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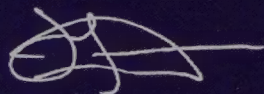


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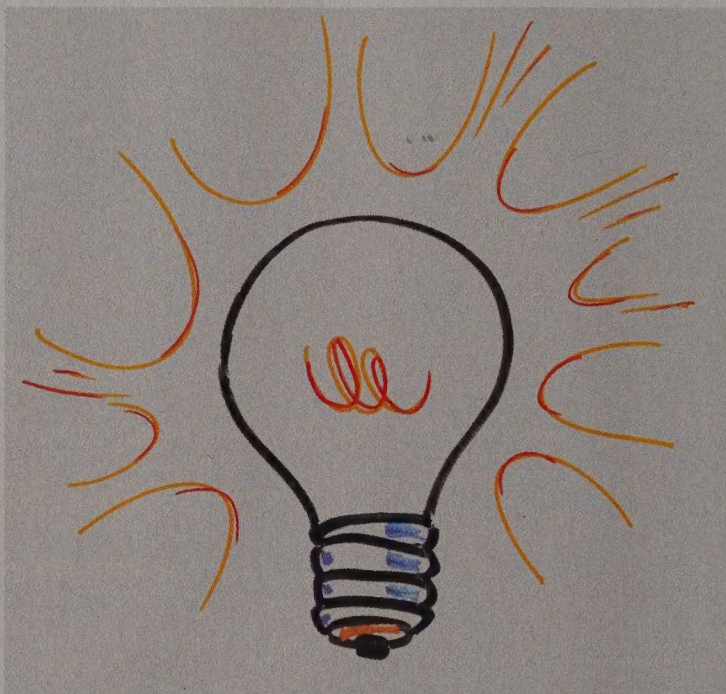


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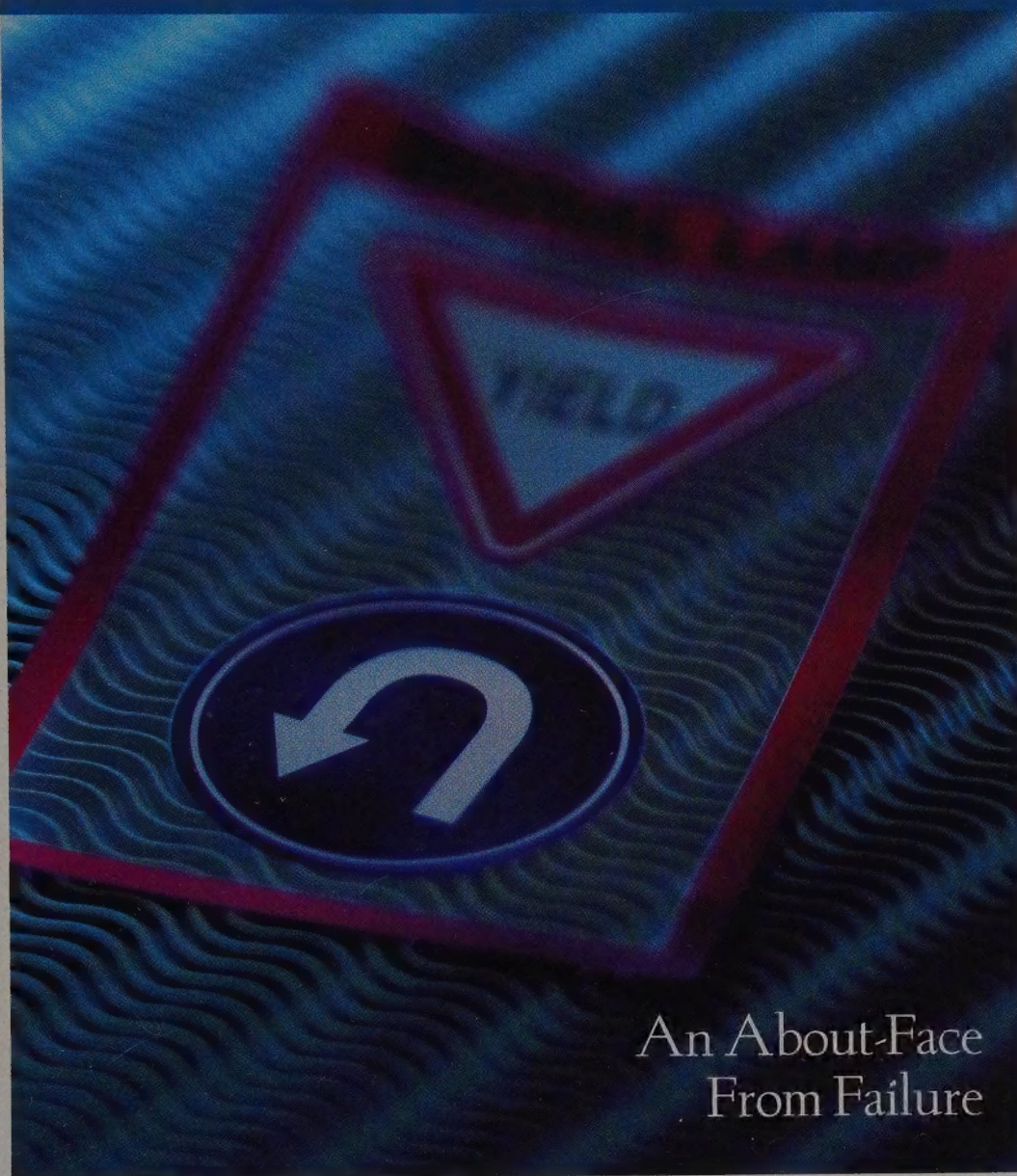
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From Failure

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Assisting Troubled Business Clients: A Midsize Dilemma for CPAs

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Voluntary Disclosure to the IRS: A Viable Option

by Stephen G. Huggard

The IRS can deal leniently with taxpayers who volunteer information against themselves about unpaid taxes. Knowing when and how to make such disclosures, however, is crucial.

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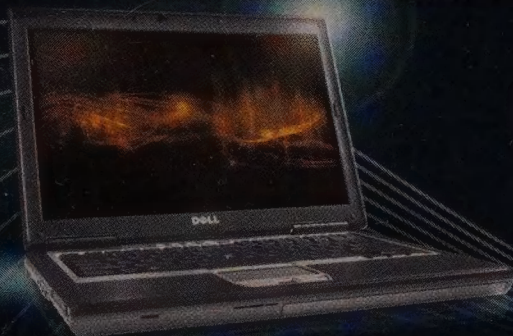
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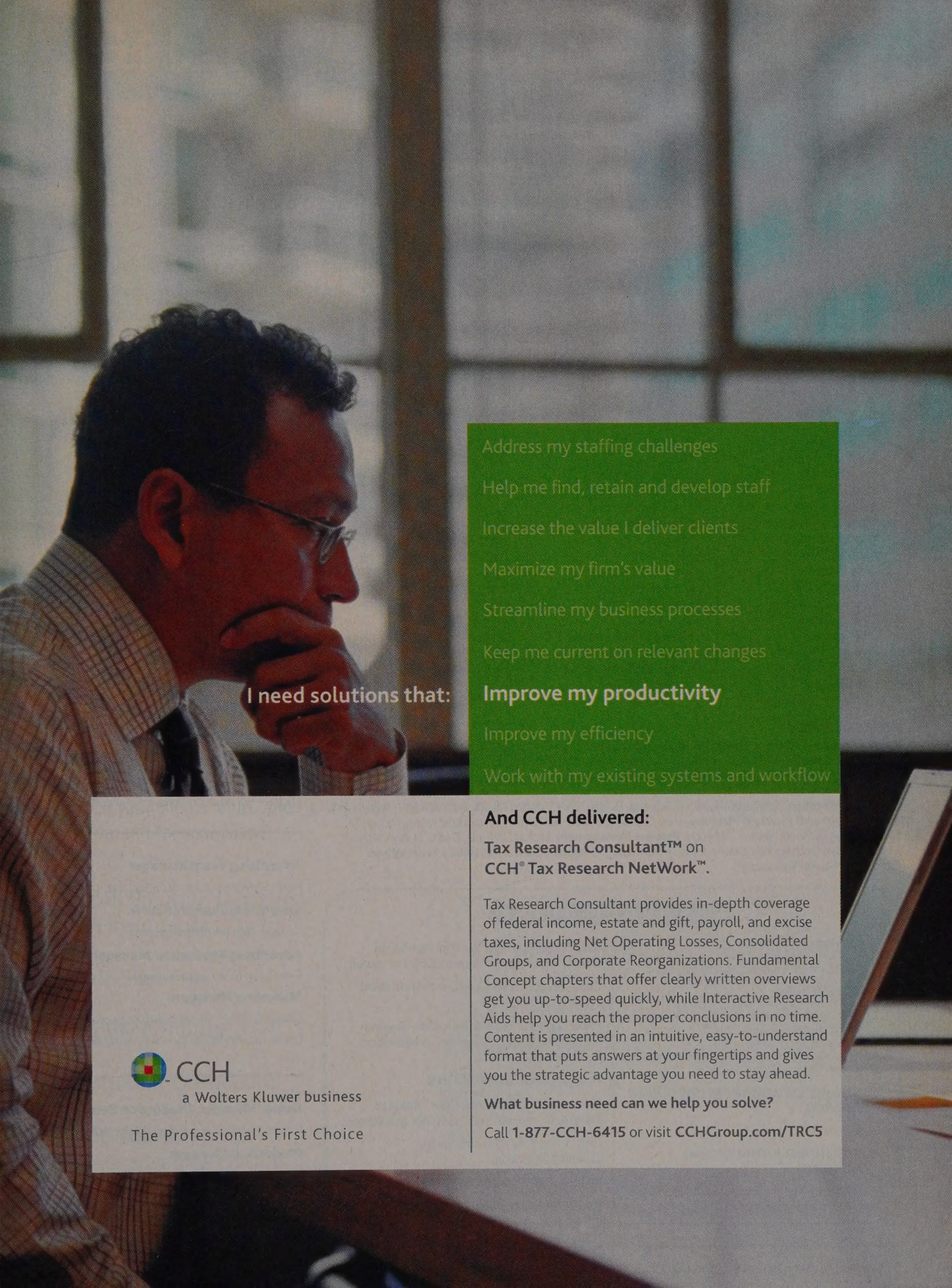
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Rocky S. Rosen (rrosen@aicpa.org)

Senior Editors

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Loanna Overcash (lovercash@aicpa.org)

Senior Assistant Editor

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Assistant Editor

Megan Pinkston (mpinkston@aicpa.org)

Copy Editors

Todd Conard (tconard@aicpa.org)

Jeffrey Gilman (jgilman@aicpa.org)

Contributing Editors

Alistair M. Nevius (anevius@aicpa.org)

Joseph T. Wells (jwells@acfe.com)

Stanley Zarowin (stanleyjoatech@gmail.com)

Administrative Assistant

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■ **Assisting Troubled Business Clients: A Midsize Dilemma for CPAs** page 34



William Y. Culbertson, Esq., CPA, MBA, has more than 30 years of experience as an industry executive, professional adviser and helping with corporate turnarounds. He is an associate professor at Northern Kentucky University's College of Business. He also conducts CPE and CLE training on the art of turnarounds and related topics in ethics.

■ **Voluntary Disclosure to the IRS: A Viable Option** page 40



Stephen G. Huggard, Esq., is a partner in the Boston office of Edwards Angell Palmer & Dodge LLP, where he represents businesses and individuals in complex civil and criminal cases, including successfully counseling clients through the voluntary disclosure process. During his 17 years as a federal prosecutor, he headed the Public Corruption and Special Prosecutions Unit at the U.S. Attorney's Office for the District of Massachusetts.

■ **Are Your ESD Values on Target?** page 44



Keith F. Sellers, CPA/ABV, CVA, DBA, is the LaGrange Eminent Scholar of Business Valuation and a professor of accounting at the University of North Alabama, where he serves as director of the Center for Business Valuation Research and Education. Previously he was on the faculties of the University of Arkansas and Fort Lewis College. He is the founder and president of Financial Valuation Services Inc., a business appraisal firm, and co-founder of Derivative Valuation Associates LLC, which develops derivative valuation software.



Yingping Huang, Ph.D., OCP, CISSP, is a co-founder and director of research and development at Derivative Valuation Associates LLC. He is also a faculty member of the College of Business at the University of North Alabama. His expertise includes quantitative finance, financial modeling and complex financial instruments valuation.

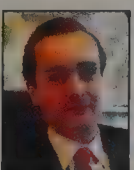


Brett A. King, Ph.D., is the State Farm Professor of Risk Management at the University of North Alabama and coordinator of graduate programs for the College of Business. He is president of Derivative Valuation Associates and co-editor of the *Journal of Business, Industry and Economics*.

■ **Allocating Value Among Different Classes of Equity** page 50



Andrew C. Smith, CPA/ABV, ASA, CVA, CMA, is a partner and senior managing director with The McLean Group, a middle market investment bank based in McLean, Va. He manages the firm's business valuation practice. He is a Financial Industry Regulatory Authority registered representative and financial and operations principal (Series 7, 28 and 63).



Jason C. Laurent, AVA, is a senior analyst with The McLean Group's corporate valuation practice. He graduated summa cum laude from George Mason University with a B.A. in accounting and finance.

■ **Take Your New Team to the Top** page 58



Pam Gillenwater is the CEO of Elinvar, an executive search firm based in Raleigh, N.C. She has more than 18 years of search experience including many CFO and other top nonfinancial positions and experience training and building high-performing teams.

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HIGHLIGHTS

■ **The SEC's Committee on Improvements to Financial Reporting** voted in January to support a slate of preliminary recommendations designed to make the information presented by U.S. public companies more useful to investors while reducing the complexity of the financial reporting system. The preliminary proposals included a call for reducing industry-specific guidance and support for an SEC policy or safe harbor provision regarding professional judgment.

The committee, with businessman Robert Pozen as chairman, also supported the following preliminary recommendations, among others:

- The FASB board and staff should include better representation for investors or financial statement users.
- FASB should improve procedures for field testing, field visits and cost/benefit analyses in standard-setting.
- The SEC should mandate the filing of XBRL-tagged financial statements within a defined time frame after certain preconditions have been satisfied relating to successful taxonomy testing and the capacity of companies to file XBRL-tagged financial statements using the new U.S. GAAP Taxonomies on the SEC's EDGAR system.
- The SEC should issue guidance stressing that those who evaluate the materiality of a reporting error should make the decision based on the perspective of a reasonable investor and that materiality should be judged based on how an error affects the total mix of information available to a reasonable investor.
- The SEC should issue a comprehensive interpretive release regarding the use of corporate Web sites for disclosures of corporate information addressing such issues as liability for information presented in a summary

format and treatment of hyperlinked information from within or outside a company's Web site.

The committee will meet March 13 and 14 and is expected to issue its final recommendations to the SEC Commission by August. More information is available at www.sec.gov/about/offices/oca/acifr.shtml.

■ **The AICPA issued Statement on Standards for Accounting and Review Services no. 16, Defining Professional Requirements in Statements on Standards for Accounting and Review Services.** The provisions, which became effective upon issuance, define certain terms used in SSARs to describe the professional requirements imposed on accountants performing a compilation or review of a nonissuer.

SSARS no. 16 defines two categories of professional requirements. Unconditional requirements, which are indicated in SSARS by the words "must" or "is required," mandate compliance in all cases that conform to the circumstances in which the unconditional requirement applies. Presumptively mandatory requirements, indicated in SSARS by the word "should," permit, in rare circumstances, departures from the mandatory requirements provided an accountant documents the justification for the departure and how the alternative procedures achieved the objectives of the presumptively mandatory requirement.

Information on the statement is available at www.aicpa.org/download/auditstd/arsc/Summary_for_AICPA_org.pdf. See also, "Official Releases," *JofA*, Feb. 08, page 106.

■ **A recent GAO report, *Audits of Public Companies*, found that concentration in the market of large public company audits by the four largest accounting firms is likely to**

continue with little adverse effect. Recent audit fee increases were attributed to expanding accounting and auditing requirements and higher personnel costs; and market participants acknowledged a general increase in audit quality. While smaller accounting firms face various challenges in expanding to audit more public companies, the majority are not interested in pursuing these clients.

Interest in the potential effects on competition and the choices available to large companies needing an auditor led to a random sample survey of almost 600 large, medium, and small public companies to obtain information on their experiences with auditors. The GAO also interviewed the four largest accounting firms and surveyed all other U.S. accounting firms that audit at least one public company.

According to the survey, 82% of large public companies saw their auditor choice limited to three or fewer firms, while around 60% viewed audit market competition as insufficient. Most small public companies reported satisfaction with auditor choices.

The report said proposals to address audit market concentration and challenges facing smaller accounting firms have gained little support because of questions raised by market participants about the effectiveness, feasibility and benefits of doing so. Due to the lack of a significant adverse effect of concentration in the current environment and no clear consensus on how to reduce such concentration, the GAO found no compelling need for immediate action.

The complete report is available at www.gao.gov/new.items/d08163.pdf.

■ **The AICPA Investment Companies Expert Panel revised an illustrative report on internal control required by the SEC** under Form N-SAR that incorporates the definitional changes to *material weakness* and *significant deficiency* as

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described in PCAOB Auditing Standard no. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*. The revision replaces the illustrative report in paragraph 11.19 of the AICPA Audit and Accounting Guide *Investment Companies* as part of 2008 conforming changes. Consistent with the effective date of AS5, the revised illustrative report is effective for audits of fiscal years ending on or after Nov. 15, 2007, with immediate adoption permitted.

More information is available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_investco.htm.

■ **SEC Chairman Christopher Cox highlighted the SEC's positions on International Financial Reporting Standards (IFRS), XBRL and mutual recognition recently at the AICPA's International Issues conference** in Washington.

IFRS. "IFRS is coming," said Cox, though he shied from giving a specific timeline in a question-and-answer session following his speech. "It's difficult to overstate the potential upside for investors of the growing consensus behind IFRS," he added.

XBRL. In discussing the SEC's support for a multinational XBRL architecture Cox said, "This will increase interoperability among XBRL databases for U.S. GAAP, IFRS, and Japan GAAP."

Mutual recognition. Cox said mutual recognition would give U.S. investors direct access to foreign markets, or possibly foreign broker-dealers, provided those entities were supervised under foreign securities regulations "substantially comparable" to those in the United States.

■ **The International Accounting Standards Board completed a joint project with FASB by issuing a revised version of IFRS 3, *Business Combinations*, and an amended version of IAS 27, *Consolidated and Separate Financial Statements*.** The revised IFRS 3 and amended IAS 27 are similar in most respects to FASB Statement no. 141(R), *Business Combinations*, and FASB

Statement no. 160, *Noncontrolling Interests in Consolidated Financial Statements*, which were issued in December. For more information, visit www.iasb.org or www.fasb.org.

■ **The Financial Crimes Enforcement Network (FinCEN) issued a pair of administrative rulings to help businesses determine whether their check cashing activities require them to register as money services businesses (MSBs) under the Bank Secrecy Act (BSA).** The BSA defines a *check casher* as "a person engaged in the business of check cashing, other than a person who does not cash checks in an amount greater than \$1,000 in currency or monetary or other instrument for any person on any day in one or more transactions."

In the first ruling, FinCEN said a company that cashes its own checks that have been issued to loan customers as loan proceeds is not an MSB. As long as the funds are disbursed to the customer who is obtaining the loan, and not to a third party, the company is in effect disbursing loan proceeds in cash and is not a check casher under the BSA. The ruling is listed as FIN-2007-R001.

In the other case, a company cashes checks for amounts greater than \$1,000 per person per day under two circumstances: (1) for the company's own employees' payroll checks; and (2) for checks or money orders payable to customers who have current obligations to the company that are due and payable, where the difference between the amount of the check and the amount the customer will pay the company to satisfy the current obligation is less than \$1,000.

FinCEN said neither circumstance required registration, though as to the second circumstance, the ruling said that the presence of a written policy posted on the business's premises would be a key factor in not requiring BSA registration. The ruling is listed as FIN-2007-R002.

The rulings are at www.fincen.gov.

■ **FDIC Chairman Sheila Bair wrote in favor of an industry-led plan announced in December that would encourage wide-scale loan modification to curb foreclosures** for subprime

homeowners before interest rates reset to unaffordable levels.

Bair's article, "The Case for Loan Modification," in the Third Quarter 2007 issue of the *FDIC Quarterly Banking Profile*, examines the current state of the U.S. housing and mortgage credit markets, especially the pending interest-rate resets of subprime ARMs. She says the loan modification program is not a "bailout" because the government is not subsidizing investors or borrowers; it is only assuring investors they have the "legal flexibility" to pursue new strategies. She also said action to limit the mortgage credit crisis will benefit the FDIC Deposit Insurance Fund, which would cover insured losses if an institution fails.

The article is available at www.fdic.gov/bank/analytical/quarterly/index.html.

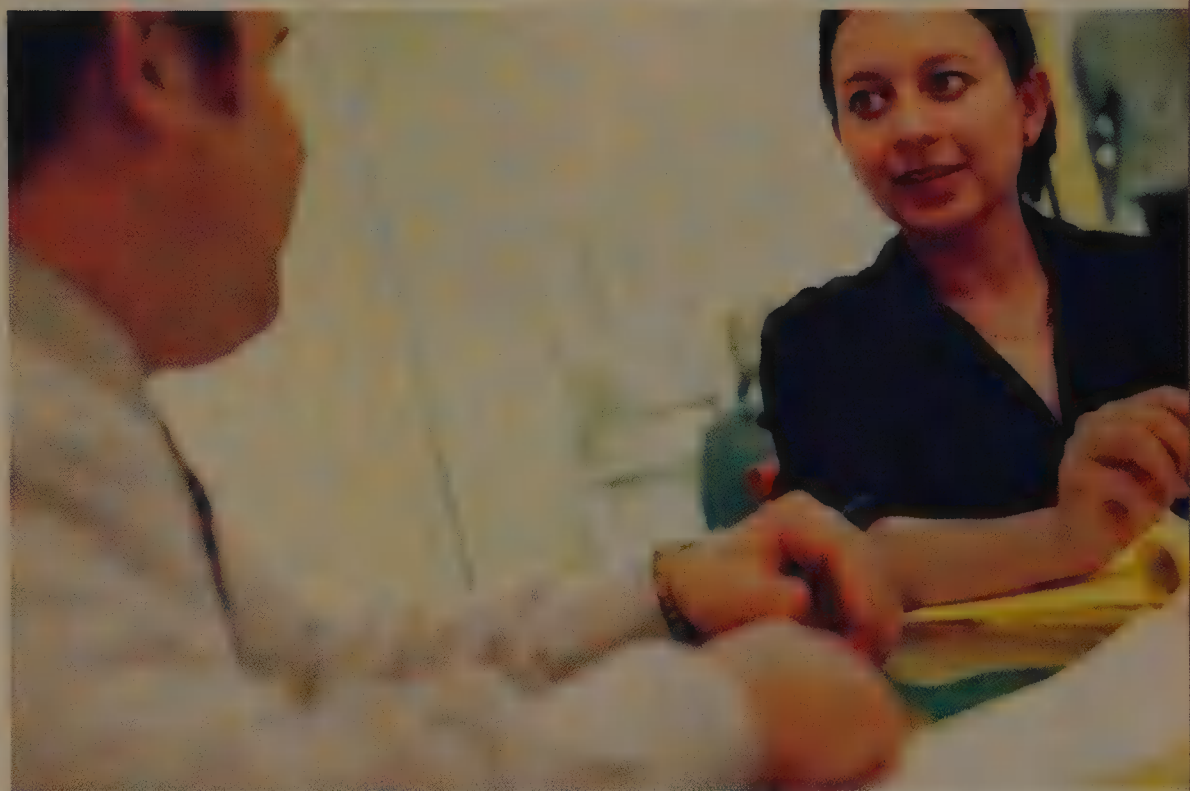
■ **FASB launched the one-year verification phase of the FASB Accounting Standards Codification.** Users who register at <http://asc.fasb.org> can review the codification for free and provide feedback on the system and on specific content. During the verification period, codification content will be updated to reflect changes resulting from constituent feedback and new standards. FASB is advising users that the codification content is not approved as authoritative and, therefore, users must verify research results using their existing resources for the currently effective literature.

The project's goal is to simplify the organization of thousands of authoritative U.S. accounting pronouncements issued by multiple standard-setters, including FASB, the AICPA, and the Emerging Issues Task Force. The codification excludes governmental accounting standards.

■ **The AICPA, in collaboration with the American Accounting Association's Management Accounting Section, is soliciting proposals for 2008 research grants** in the area of management accounting. The AICPA will fund one or more projects with grants of up to \$75,000. The deadline for proposals is March 31. Guidelines are available at <http://fmcenter.aicpa.org/>. ♦

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topline

News, People, Trends and Other Noteworthy Items

AS QUOTED

“The plan to take a fresh look at the preparer penalty regulations will be a top priority for us in 2008.”

—IRS Chief Counsel Donald Korb



CONTINUING EDUCATION

IRS CPE Program Tackles International Tax Treaties

The Service will present a free webcast titled “International Tax Issues: Understanding Tax Treaties” on March 11 as part of its Tax Talk Today program.

Panelists will discuss how to apply tax treaties to returns and how to get treaty benefits in foreign countries. The U.S. has treaties with more than 60 countries that could reduce tax and eliminate double tax for your clients involved in overseas employment and transactions.

The program is hosted by Phyllis Grimes, chief stakeholder liaison for industry outreach with the Small Business/Self-Employed Division of the IRS. To register for this program or purchase the accompanying continuing education credit, visit www.taxtalktoday.tv.

Source: www.taxtalktoday.tv/index.cfm?page=8.774.

FRAUD

Electronic Hooky

Supervisors beware—an Oklahoma company has taken fake excuses to a new level.

The Excused Absence Network produces software templates to create legitimate-looking excuse notes that appear to come from local doctors and hospitals, available for purchase for about \$25. Other forms offered include a phony jury summons and funeral notices.

While the company’s disclaimer states the notes are “for entertainment purposes only,” at least one customer did not take the warning to heart. The Associated Press reported that a New Jersey woman was arrested after using one of the company’s notes to avoid an appearance in traffic court.

A CCH survey found an unscheduled absenteeism rate of 2.3% for 2007, down from 2.5% in 2006, though there were no exact figures on the cost of fake absences to companies.



—Joseph T. Wells, CPA, CFE

TECH TALK

CPA Firm Sites—Dos and Don'ts

- 
- **DO register the domain yourself.** A third party can easily register it in their name, making themselves an administrator—then your Web site becomes their property.
 - **DO present a précis of your practice on the home page.** Don't use a "Welcome" message.
 - **DON'T use frivolous graphics,** which often turn off visitors. If used, graphics should relate to the text and help communicate a message to set you apart from the competition.
 - **DON'T use Flash.** It takes too long to load and isn't worth the extra cost.
 - **DON'T complicate the site's navigation with multiple subtopics.** They could confuse or mislead visitors.
 - **DO consider how visitors read your site.** Eye-tracking visualization studies indicate that Web visitors read sites in an F-shaped pattern, starting with horizontal movement across the banner, left to right, returning to the left side, then down to the first paragraph.
 - **DO be succinct.** If your home page is not concise, visitors will not bother to navigate to secondary pages.
 - **DO keep secondary pages easy to read.** They should explain the home page content in greater detail and delve deeper into your practice.
 - **DON'T include fluff;** especially adjectives that take up space and mean nothing. What's important is not what you say about yourself, but your experience and client testimonials.
 - **DO have a separate Web site if you also provide investment advisory services.** As an investment adviser, the firm has to abide by several regulatory and professional guidelines; it's important to include text assuring conformance to these regulations.
 - **DO design your site to be different.** Beware of the cookie-cutter look, and don't be afraid to stand out from the competition.
 - **DON'T use bright primary colors on the site's background,** particularly white text on red or royal blue. Content will be hard to read, and visitors will tune out.
 - **DO describe your area of specialization.** Potential clients may not be aware of the profession's boundaries or definitions.
 - **DO communicate trust and credibility.** You're in a personal service business, and nothing is more important to a client than knowing you can be trusted.

Source: Margot W. Teleki, partner, CopyWrite Marketing Group, www.copywritemarketinggroup.com.

TECH TALK

Federal Budget Goes Paperless

For the first time, the federal budget goes green.

The 2009 fiscal year budget is available online at www.budget.gov. The digital document, whose four-book print version contained nearly 2,200 pages, is fully searchable and available for download.

Office of Management and Budget Director Jim Nussle expects the E-Budget to save nearly 20 tons of paper—or around 480 trees—and save close to \$1 million over the next five years.



Source: www.whitehouse.gov/omb.

ON THE RECORD

Late-Year Code Changes Go Unnoticed

"When taxpayers do not claim tax benefits because they do not know about them, Congress' intent in providing the tax benefits is undermined and taxpayers understandably question the fairness of the tax system."

—National Taxpayer Advocate Nina E. Olson, Jan. 9

Source: www.irs.gov.

ETHICS

Yours or Mine?

Rather than implementing traditional compliance program control elements—including codes, training and whistleblowing systems—when dealing with third parties, more and more global companies are educating their own employees and choosing to work with those suppliers who are ethically compatible.

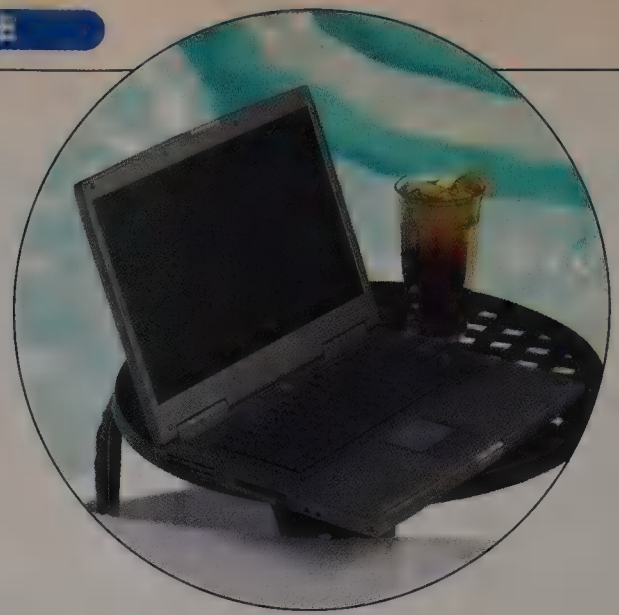
According to *Finding a Delicate Balance: Third Party Ethics Requirements*, a report by The Conference Board and the Ethics and Compliance Officer Association, most of the companies surveyed said they preferred to use their own code of conduct for employees when it comes to dealing with third parties and compliance risk.

Why? Not only can compliance programs be difficult to implement, but imposing requirements on suppliers may also give rise to expectations that exceed the company's ability to monitor or enforce its compliance standards.

The survey also found that most companies considered a partner's ethical fit the key to maintaining high third-party business conduct standards.



Source: The Conference Board's *Finding a Delicate Balance: Third Party Ethics Requirements*, www.conference-board.org.



CAREERS AND RECRUITING

Work/Life Balancing Act

In studying hiring trends for 2008, CareerBuilder.com found that almost 40% of employers plan to increase their offerings of flexible work arrangements (60% currently offer some form of flexible scheduling). These arrangements include:

- Alternate schedules (78%)
- Compressed workweeks (38%)
- Telecommuting options (33%)
- Summer hours (21%)
- Job sharing (18%)
- Sabbaticals (8%)

Other trends included the rehiring of retirees from other companies, screening job candidates using online search engines and social networking sites, and hiring freelance or contract workers.

Source: CareerBuilder's *Job Forecast 2008*, www.careerbuilder.com.



DATA POINT

85

Percentage of privacy and security professionals who reported at least one data breach of personally identifiable information of customers or employees within the past 12 months.

Source: *Enterprise@Risk: 2007 Privacy & Data Protection Survey*, Deloitte & Touche LLP, www.deloitte.com, and Ponemon Institute, www.ponemon.org.

CAREERS AND RECRUITING

Show a Soft Side

You've got technical know-how, but can you explain your skills and accomplishments in an interview?

More than half (53%) of the 1,400 CFOs surveyed by Robert Half Management Resources said they would be willing to hire someone with fewer technical skills if the candidate had stronger soft skills, such as communication and interpersonal abilities.

Source: www.roberthalfmr.com.



BUSINESS TRENDS

Consumer Bankruptcy Soars

According to the American Bankruptcy Institute, consumer bankruptcy filings increased almost 40% in 2007.

Data from the National Bankruptcy Research Center showed 801,840 filings between Jan. 1 and Dec. 31, up from 573,203

filings recorded during the same period in 2006. ABI Executive Director Samuel J. Gerdano attributed the spike in filings to the mortgage crisis.

Source: American Bankruptcy Institute, www.abiworld.org.



TONE AT THE TOP

Family Firms Lax on Succession, Management

In its first global survey of family-owned businesses, PricewaterhouseCoopers found almost half of family firms lack a succession plan; when it comes to companies founded in the last 20 years, the number jumps to 60%. Among businesses that had drawn up a plan, only 48% had chosen a successor.

Of the one-quarter of family businesses projected to change hands over the next five years, 51% were expected to remain in the family. But according to the survey data, this transition may not be so easy.

Other findings included:

- Fewer than 30% of family businesses had adopted conflict-resolution procedures.
- Two-thirds had no defined criteria for deciding which family members should be allowed to take active roles in the company.
- Almost three-quarters said hiring and training good, new employees was their first priority.

For the survey, PwC interviewed almost 1,500 small and medium-sized family businesses (defined as companies where family members comprise the majority of the senior management team, hold at least 51% of the shares and where owners have day-to-day management responsibilities) from 28 countries.



Source: *Making a Difference: The PricewaterhouseCoopers Family Business Survey 2007/08*, www.pwc.com.

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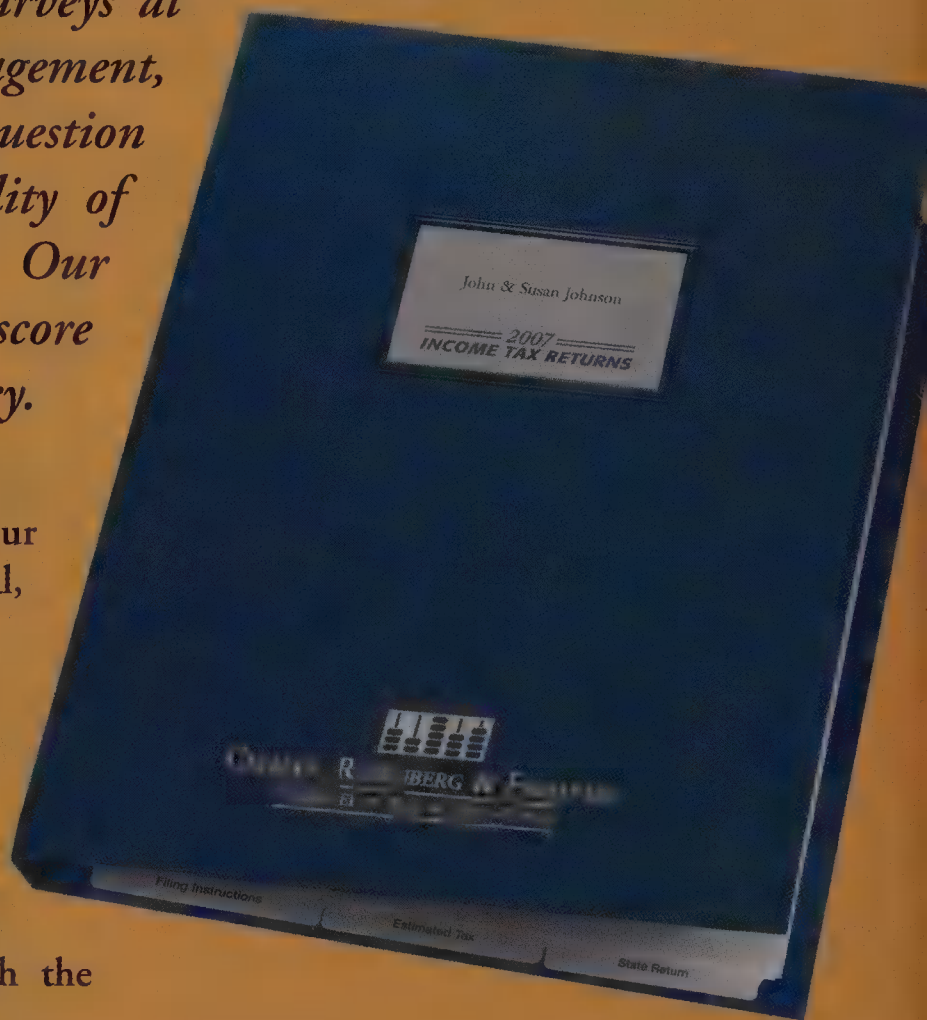
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JOURNAL OF ACCOUNTANCY News Digest

AUDITING

■ The PCAOB published a staff audit practice alert on auditing fair value measurements in financial statements.

"We were motivated to develop and issue this alert by the auditing challenges presented by the subprime credit situation and its effects on the markets and fair value measurements, and certain issues that might arise in the transition" to FASB Statement no. 157, *Fair Value Measurements*, Marty Baumann, director of the PCAOB Office of Research and Analysis, said in a news release.

The alert, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, creates no new requirements. It highlights matters in four areas:

- Auditing fair value measurements.
- Classification of fair value measurements within the fair value hierarchy established by Statement no. 157.
- The use of specialists in fair value measurements.
- The use of pricing services in fair value measurements.

The alert is available at www.pcaobus.org/Standards/Staff_Questions_and_Answers/2007/12-10_APA_2.pdf.

BANKING

■ The FDIC issued a proposed rule to improve the process of determining uninsured depositors at large institutions and enhance the regulator's ability to make funds available promptly to insured customers if a large financial institution is closed.

Certain larger, or so-called "covered" institutions, would be required to adopt mechanisms that, in the event of a failure, would place provisional holds on large deposit accounts in a percentage specified by the FDIC; provide the FDIC with deposit account data in a standard format; and allow automatic removal of provisional holds once the FDIC has made an insurance determination. "Covered" institutions include banks with \$2 billion in domestic deposits and either (1) more than 250,000 deposit accounts or (2) total assets of more than \$20

billion. In December, there were 159 FDIC-insured institutions meeting these criteria.

Other proposed requirements that would apply to all FDIC-insured institutions govern the specific time and circumstances under which account balances are determined in the event of a failure. The FDIC is proposing the use of end-of-day ledger balances as normally calculated by the institution.

In a news release, the FDIC said it has usually been able to allow most depositors access to their deposits on the next business day after a closure, and that the proposed rules would better enable the FDIC to continue this practice.

The proposed rules are available at www.fdic.gov/news/board/07Dec19_NPRClaims.pdf. Comments will be accepted until April 14.

■ The Office of the Comptroller of the Currency revised the asset-size thresholds used to define "small bank" and "intermediate small bank" in regulations to the Community Reinvestment Act.

Beginning Jan. 1, 2008, banks that as of Dec. 31 of either of the prior two calendar years had assets of less than \$1.061 billion are "small banks." Small banks with assets of at least \$265 million as of Dec. 31 of either of the prior two calendar years and less than \$1.061 billion as of Dec. 31 of either of the two prior calendar years are "intermediate small banks."

The rule was issued jointly with the Federal Reserve, the FDIC and the Office of Thrift Supervision. The full text is available at www.occ.treas.gov/fr/fedregister/72fr72571.pdf.

EMPLOYEE BENEFITS

■ The Treasury Department and the IRS issued proposed regulations on Pension Protection Act funding rules. REG-139236-07, *Measurement of Assets and Liabilities for Pension Funding Purposes*, will provide employers who sponsor single-employer defined benefit plans with guidance regarding the measurement of pension assets and liabilities under the new funding rules. Plan sponsors need to determine the contribution requirements that apply to their defined benefit plans for the first year that the new funding rules apply. The new funding rules are generally effective for plan years beginning on or after Jan. 1, 2008, with the regulations being proposed to be effective for plan years beginning on or after Jan. 1, 2009. Plan sponsors can rely on these proposed regulations for purposes of satisfying section

■ For news from the AICPA and state societies, visit www.cpa2biz.com, which also offers online CPE, AICPA professional literature, practice management aids and links to state society Web sites.

430 requirements for plan years beginning in 2008.

FINANCIAL REPORTING

■ FASB's Emerging Issues Task Force issued a draft abstract intended to improve the comparability of earnings per unit calculations for master limited partnerships. The abstract addresses how current-period earnings of a master limited partnership should be allocated to general partners, limited partners, and, when applicable, incentive distribution rights, when applying EITF Issue no. 07-4, *Application of the Two-Class Method Under FASB Statement No. 128, Earnings per Share, to Master Limited Partnerships*.

Comments on the abstract were due Feb. 8 and are scheduled to be considered by the task force at its meeting March 12-13. The draft is available at www.fasb.org/eitf/0704DA2.pdf.

GOVERNMENT

■ The Federal Accounting Standards Ad-

visory Board (FASAB) issued Statement of Federal Financial Accounting Concepts 5 (SFFAC5), *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements*. The document defines assets, liabilities, net position, revenues and expenses.

SFFAC5 is the fifth in a series of concepts statements intended to set forth a framework of objectives and fundamentals on which financial accounting and reporting standards will be based. The statements do not actually establish new financial accounting standards.

"This foundation will ensure that the accounting standards lead to financial statements that provide information that is comparable across agencies and programs," FASAB Chairman Tom Allen said in a news release.

The document is available at www.fasab.gov/codifica.html.

■ A GAO study of accrual budgeting determined that it does not provide enough information about the nation's long-term

fiscal challenges. Instead, increased reporting on long-term budgetary implications of major tax and spending programs should be required, the GAO said. The Senate Budget Committee asked the GAO to update its 2000 study of other nations' experiences with accrual budgeting in order to determine how they are increasing attention to long-term fiscal challenges.

The study reviewed the use of accrual budgeting in Australia, Canada, Iceland, the Netherlands, New Zealand and the U.K. While these countries have used accrual budgeting differently, in some cases to increase transparency and improve government performance, it has not been used to measure long-term fiscal challenges. Instead, many of the countries prepare fiscal sustainability reports to assess the overall sustainability of government finances.

The GAO recommends that accrual budgeting be explored for certain programs to ensure an informed incentive and budget decision-making process. Pe-

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riodic reports on fiscal sustainability should also be required for the government as a whole, the GAO said. The report is available at www.gao.gov/new.items/d08206.pdf.

INTERNATIONAL

■ The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board under the auspices of the International Federation of Accountants (IFAC), proposed three new standards; two would focus on enhancing auditors' consideration of controls at service organizations and a third would address communicating deficiencies in internal control to those charged with governance.

Following a risk-based approach, proposed International Standard on Auditing (ISA) 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Third Party Service Organization*, deals with the auditor's responsibilities to obtain audit evidence when an entity uses one or

more service organizations. This may include obtaining reports prepared by the auditors of those organizations.

Proposed International Standard on Assurance Engagements (ISAE) 3402, *Assurance Reports on Controls at a Third Party Service Organization*, is the first subject matter-specific standard developed under the IAASB's *International Framework for Assurance Engagements*. Reports prepared in accordance with proposed ISAE 3402 will be capable of providing appropriate audit evidence under proposed ISA 402 (Revised and Redrafted).

The IAASB also is seeking comments on proposed ISA 265, *Communicating Deficiencies in Internal Control*, which deals with the auditor's responsibility to communicate to management and those charged with governance deficiencies in internal control that have been identified by the auditor. It distinguishes between significant and other deficiencies in order to establish requirements to communicate to the appropriate levels within the audited entity.

Comments on proposed ISA 402 (Revised and Redrafted) and proposed ISA 265 are due April 30. Comments on proposed ISAE 3402 are due May 31. The exposure drafts are available at www.ifac.org/EDs.

■ The International Accounting Education Standards Board, an independent standard-setting board of IFAC, released guidance to assist its member organizations and others in establishing effective practical experience programs. The new guidance is contained in International Education Practice Statement (IEPS) 3, *Practical Experience Requirements—Initial Professional Development for Professional Accountants*. IEPS 3 provides guidance on the period of practical experience, content of practical experience requirements, and the roles and responsibilities of IFAC members as well as mentors and employers.

The practice statement suggests how IFAC members and associates may meet the requirement for a period of practical



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experience for trainees to qualify as professional accountants. It also explains how workplace output can be used to assess competence developed by trainees during that period. The guidance can be downloaded for free from the IFAC online bookstore at www.ifac.org/store.

■ The trustees of the International Accounting Standards Committee (IASC) Foundation, the oversight body of the International Accounting Standards Board (IASB), published amendments to the IASC Foundation's constitution that enlarge the International Financial Reporting Interpretations Committee (IFRIC) to 14 members from 12 members and amend the quorum and voting requirements accordingly. The changes are intended to give IFRIC membership greater diversity of practical experience, according to a press release. To view the amended constitution visit www.iasb.org/About+Us/About+the+Foundation/Constitution.htm.

■ The International Accounting Standards Board (IASB) published an exposure draft of proposed amendments to International Financial Reporting Standard (IFRS) 2, *Share-Based Payment*, and International Financial Reporting Interpretations Committee (IFRIC) 11 *IFRS 2, Group and Treasury Share Transactions*. The proposals respond to requests for guidance on how a group entity that receives goods or services from its suppliers (including employees) should account for the following arrangements:

Arrangement 1. The entity's suppliers will receive cash payments that are linked to the price of the equity instruments of the entity.

Arrangement 2. The entity's suppliers will receive cash payments that are linked to the price of the equity instruments of the entity's parent.

Under either arrangement, the entity's parent has an obligation to make the required cash payments to the entity's suppliers. The entity itself has no obligation to make such payments. The proposed amendment to IFRS 2 clarifies that IFRS 2 applies to arrangements such as those described above even if the entity that re-

ceives goods or services from its suppliers has no obligation to make the required share-based cash payments. The proposed amendment to IFRIC 11 specifies that the entity should measure the goods or services in accordance with the requirements for cash-settled share-based payment transactions. To download the ED, visit www.iasb.org/Open+to+Comment/Open+to+Comment.htm. Comments are due by March 17.

INVESTING

■ The SEC launched an online tool that enables investors to instantly compare what 500 of the largest American companies are paying their top executives. The database highlights the power of interactive data to transform financial disclosure. The Executive Compensation Reader is available at www.sec.gov/xbml. It uses XBRL technology and includes direct links to companies' proxy statements, including footnotes and the companies' explanations of their compensation decisions.

■ The SEC posted on its Web site a report titled *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*. In a news release, the SEC said changes in the financial services market have contributed to a lack of boundaries between investment advisers and broker-dealers, causing the SEC to want a clear understanding of the industry's complexities for future regulatory reform. The agency commissioned the RAND Corp. to study the state of the investment advisory and brokerage industries to determine:

■ The current business practices of broker-dealers and investment advisers

■ If investors understand the differences between and relationships among broker-dealers and investment advisers

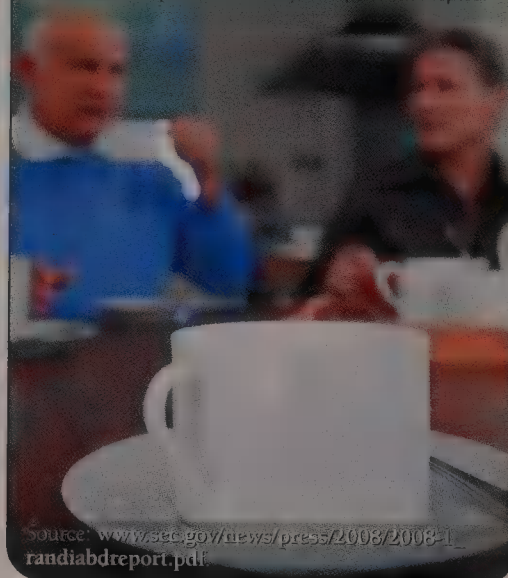
The study found that although investors fail to distinguish between broker-dealers and investment advisers according to federal regulation definitions, they still express a high level of satisfaction with the services received from their financial service providers. The study

Firms Grow Through Referrals

In an SEC-commissioned survey for the *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* report, respondents were asked what method they used to locate their current financial services firm. Their responses included:

Referral from family or friend	28.9%
Professional referral	18.1%
Print or television ad	16.8%
Internet	8.4%
Mailing	2.4%
Other	36.1%

* Includes 19 explanations. Multiple responses accepted.



Source: www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf

does not evaluate the legal or regulatory environment and does not make policy recommendations. Rather, "the report will assist the Commission's efforts to update our regulations to improve investor protections in today's new marketplace," SEC Chairman Christopher Cox said in the release.

The entire report is available at www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

SECURITIES

■ The number of companies sued in securities class action litigation rose 43% between 2006 and 2007, to 166 from 116, according to a report by the Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research. Litigation activity for 2007 was 14% below the

Securities Class Action Filings by Industry

Of the 166 filings in 2007, 28% came in the finance sector, more than double the average portion of litigation activity measured in that sector between 1997 and 2006 (12%).

Industry	2006	1997-2006	1997-2006
Finance	47	47	24
Consumer (non-cyclical)	37	36	48
Communications	5	23	31
Consumer (cyclical)	13	19	24
Industrial	13	10	19
Technology	22	12	31
Other	5	9	12
Total	116	166	194

Source: Securities Class Action Case Filings 2007: A Year in Review, Stanford Law School Class Action Clearinghouse and Cornerstone Research

10-year historical average (1997–2006) of 194 companies sued per year, but the report noted that activity jumped in the second half of 2007 as the subprime mortgage crisis unfolded and stock market price volatility increased.

One hundred companies were sued in the second half of the year, a litigation rate that reversed a trend of eight consecutive quarters with below average litigation activity. Of the filings in the second half of the year, 23 were related to subprime issues.

This year's report for the first time tracked the outcome of cases filed in previous years. Of cases filed between 1996 and 2001, 35% were dismissed and 64% were settled. The median time from filing to settlement was 33 months.

The report is available at http://securities.stanford.edu/clearinghouse_research/2007_YIR/20080103-01.pdf.

FYI

■ The National Association of Black Accountants' board of directors named Gregory Johnson, CPA, the organization's executive director. Before joining the NABA staff, Johnson served as director of quality control for Grant Thornton International. He created methods to monitor GTI member firms' audit practices on a global basis and administered its audit review program. He also was responsible for communication and research initiatives related to quality control. Before joining GTI, Johnson held several key positions at the AICPA, including manager of minority initiatives, director of CPA examination external relations, and director of CPA examination strategy. Johnson began his career at PricewaterhouseCoopers. ♦

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WASHINGTON REPORT

2007 in Review: Congressional Impact on CPA Profession

by *Lisa M. Dinackus*
AICPA Congressional & Political Affairs Team

Last year, CPAs had plenty of reasons to pay attention to policymakers' proposals. Legislation under consideration has the potential to improve tax practices, alter audit practices, and even pave the way for greater competition.

■ AICPA VP Testifies Before Senate Panel on International Accounting Standards

Last fall, the Senate Banking Committee's Subcommittee on Securities, Insurance, and Investment invited the AICPA to present its view on International Accounting Standards. The hearing, led by Sen. Jack Reed, D-R.I., the subcommittee's chairman, focused on International Accounting Standards and convergence with GAAP. Chuck Landes, AICPA vice president—Professional Standards, testified on behalf of the profession. His testimony supported convergence, but noted the challenges ahead and the need for education and advance preparation.

■ Treasury Advisory Committee on the Auditing Profession

In May 2007, Treasury Secretary Henry Paulson established the Treasury Advisory Committee on the Auditing Profession. Paulson named former SEC Chairman Arthur Levitt Jr. and former SEC Chief Accountant Don Nicolaisen as its co-chairmen. Then, in October, he announced 19 prominent appointees to serve on the committee, including: AICPA President and CEO Barry Melancon; KPMG Chairman and CEO Timothy Flynn; former Federal Reserve Chairman Paul Volcker; and former SEC Chief Accountant Lynn Turner.

The committee was established to encourage a more sustainable auditing profession as part of the president's effort to enhance U.S. capital market competitiveness. The committee is charged with developing recommendations, taking into consideration the issues impacting the sustainability of the auditing profession.

The committee has laid out an ambitious schedule. The panel held an inaugural meeting on Oct. 15, in Washington and conducted a full day of hearings on Dec. 3. To handle the

committee's far-reaching agenda, it has subdivided its membership into three subcommittees: Human Capital; Firm Structure and Finance; and Competition and Concentration. The subcommittees will gather data, hold hearings on their respective portfolios of issues, and report back to the full committee.

To fulfill its mandate, the committee has also requested a large amount of information from the profession, and we have been actively working to comply with that request. Numerous hearings and meetings are scheduled throughout the year, culminating in a final report currently scheduled to be completed in late summer.

The AICPA is committed to doing all we can to ensure the committee's final report best reflects optimal and constructive solutions to challenges facing the profession.

■ Changes to Farm Credit System Lending

The Farm Credit System is asking for changes in its lending authority that would allow a wide expansion of its charter to offer loans and other financial services to businesses that weren't previously included in its lending mandate. By becoming eligible borrowers in the Farm Credit System, these additional businesses could become recipients of tax, accounting, and other financially related services.

Examples of these newly eligible businesses would include hardware stores, truck and farm equipment dealers, transportation companies, small manufacturers, and similar businesses that sell their goods and services to farmers. Given the government tax and funding advantages that the Farm Credit System institutions enjoy, private sector accounting firms would find it difficult to compete with Farm Credit System institutions in this broad sector of business clients. The AICPA strongly opposes this change.

The House passed a farm bill that eliminated the expanded lending authority the Farm Credit System requested and received at the committee level. The Senate also passed a farm bill that did not include any expanded lending authority for the Farm Credit System.

The conference on the farm bill is scheduled to begin soon. We will work in conference to ensure that the FCS will not receive authority to offer financial services to newly eligible borrowers.

■ Mobile Workforce Bill

The Mobile Workforce State Income Tax Fairness and Simplification Act of 2007, HR 3359, would limit state or local taxation of the compensation of any employee who performs duties in more than one state or locality to: (1) the state or locality of the employee's residence; and (2) the state or locality in which the employee is physically present performing duties for more than 60 days.

The bill's sponsors, Reps. Hank Johnson, D-Ga., and Chris Cannon, R-Utah, held a hearing on the bill in the House

Judiciary Commercial and Administrative Law Subcommittee in November. The AICPA submitted written testimony for the record. As a result of the hearing, the state tax administrators and the coalition of businesses supporting a change in the law are currently negotiating the terms of an agreement. If agreement on an acceptable compromise can be reached, the committee is likely to report out a bill containing that compromise. The AICPA supports this legislation and will work with Congress to enact a strong bill this year.

■ Federal Housing Administration (FHA) Financial Statement Audits

The credit crisis has fueled heightened interest in Congress on legislation to revamp the Federal Housing Administration's (FHA) mortgage insurance program, to improve the availability of credit in the home mortgage market.

by Congress.

The Senate bill does not include an audit provision. Sen. George Voinovich, R-Ohio, introduced legislation to make improvements in the FHA program (S 2325), which includes the surety bond provision, but this bill is not expected to be considered.

This year, a House-Senate Conference Committee is expected to iron out the differences in the two bills and send a compromise bill to the president. The AICPA will continue to work to ensure that the House provision is not part of the final FHA bill.

■ Attempts to Amend the Sarbanes-Oxley Act of 2002

Eight pieces of legislation were introduced in 2007 in the House and Senate to modify section 404 of the Sarbanes-Oxley Act. These ranged from an exemption, to a postponement, to an election whether or not to comply. In the House, Rep. Scott Garrett, R-N.J., introduced an amendment to the SEC

Congress about the usefulness of internal controls.

The bills that were introduced included:

- Small Business SOX Compliance Extension Act, HR 2727, sponsored by Rep. Garrett. This bill was offered successfully as an amendment to the SEC funding bill, HR 2829, which passed the House. No action has been taken in the Senate.
- Competitive and Open Markets That Protect and Enhance the Treatment of Entrepreneurs (COMPETE) Act, HR 1508, sponsored by Rep. Gregory Meek, D-N.Y.
- COMPETE Act, S 869, was offered by Sen. Jim DeMint, R-S.C., as an amendment to an unrelated education bill on the Senate floor and was defeated, 62–35.

■ Small Business Tax Flexibility Act ("Workload Compression")

The Small Business Tax Flexibility Act, S 270, was introduced in January 2007. It was scored by the Joint Committee on Taxation at \$6.8 billion over 10 years. Alternatives were also scored, including a proposal that limited the scope of the ability of partnerships and S corporations to adopt a fiscal year that is other than a calendar year. The major provision of the alternative is that it would sunset in five years. Since the cost of S 270 as introduced is merely a deferral of the payment of taxes, having a sunset within the budget window reduces the cost to a negligible amount—\$24 million over 10 years—because the deferred taxes are all ultimately recovered.

This alternative is a demonstration project. We believe it will show that the benefits that will accrue to small businesses and to small CPA firms are real and significant. Also, we believe that the actual cost to the Treasury will prove to be far less than the \$6.8 billion that has been scored.

Eight pieces of legislation were introduced in the House and Senate to modify section 404 of the Sarbanes-Oxley Act.

In December, the Senate passed the FHA Modernization Act of 2007 (S 2338). Earlier in 2007, the House passed the Expanding American Homeownership Act of 2007 (HR 1852).

The House FHA bill contains a provision strongly opposed by the AICPA because it would unwisely lower broker standards and result in higher FHA defaults and greater taxpayer risk. The provision would allow a correspondent lender or mortgage broker to post a surety bond, in lieu of any requirement to provide audited financial statements or meet a minimum net worth requirement. The bill would require a General Accountability Office study of the provision's effects on mortgage defaults, and sunset in five years unless reauthorized

appropriations bill that would have withheld funds from the SEC for enforcement of section 404 for non-accelerated filers. No comparable language was in the Senate version of the appropriations bill.

Additionally, the banking industry raised the issue of the "conflict" between the Federal Deposit Insurance Corporation Improvement Act (FDICIA) internal control requirements for banks and section 404.

The SEC and the PCAOB both had rulemakings to "right-size" section 404 compliance. These rules are intended to alleviate the unnecessary burden on small businesses. The AICPA submitted official comments on the proposals.

Throughout the year, the AICPA worked to educate members of

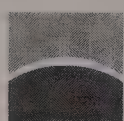


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The AICPA is working to get the demonstration project offered as an amendment to any feasible legislation that is moving through Congress this year. Last year, the AICPA grass roots was activated to highlight the workload compression issue with eight key members of the House and Senate.

Rep. Nydia Velazquez, D-N.Y., the chairwoman of the House Small Business Committee, has introduced a bill outlining her view of necessary tax breaks to aid small businesses (HR 46). Included in her bill is our Small Business Tax Flexibility Act.

Tax Strategy Patents

Early in 2007, the AICPA worked on coming up with an appropriate fix to the problem caused by the issuance of patents on tax strategies. This resulted in HR 2365, introduced by Reps. Rick Boucher, D-Va., Bob Goodlatte, R-Va., and Steve Chabot, R-Ohio, in May. The bill would allow the patenting of tax strategies, but prohibit the patent holder from enforcing the patent. A Key Person Alert was sent to Key Persons for House Judiciary Committee members asking them to support the bill. Ultimately, the bill had 40 co-sponsors.

In July, the House Judiciary Committee marked up a major patent reform bill. Our bill was included in the major bill voted out of committee, but our bill was modified to prevent the patenting of tax strategies. On Sept. 7, the House passed the bill (HR 1908), 220-175.

In November, Senate Finance Committee Chairman Max Baucus, D-Mont., and Ranking Member Chuck Grassley, R-Iowa, crafted a bill (S 2369) specifically designed to ban tax strategy patents. It was co-sponsored by Sens. Carl Levin, D-Mich, Ron Wyden, D-Ore., Barack Obama, D-Ill., Jeff Bingaman, D-N.M., and Norm Coleman, R-Minn. The bill largely follows the House-passed language and is expected to be offered as an amendment to the comprehensive patent reform bill

(S 1145) when it is considered on the Senate floor sometime this year.

More Likely Than Not

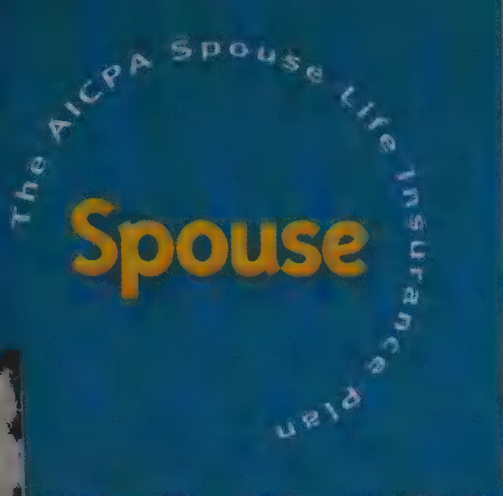
In May, the tax preparer standard was raised to "more likely than not" (or 51% probability) that a position taken about an item on a tax return is correct. If the tax preparer can't reach that standard in his or her judgment, he or she must make disclosures to the IRS about that tax position.

The AICPA has engaged other professional associations to participate in a coalition focused on solving the MLTN issue including: the ABA Tax Section, the National Association of Black Accountants, the National Association of Enrolled Agents, the National Association of Tax Professionals, the Tax Executives Institute, and the National Society of Accountants.

The AICPA, along with 28 state CPA societies, contacted members of Congress on the House Ways and Means Committee and the Senate Finance Committee. The AICPA told Congress that the problem that was created by the new disparate standard should be fixed by equalizing the Internal Revenue Code section 6694 tax return preparer standards and the taxpayer standards at the "substantial authority" level for non-tax shelter ("non-tax avoidance") items instead of at the "more likely than not" level.

In November, Reps. Joe Crowley, D-N.Y., and Jim Ramstad, R-Minn., introduced HR 4318, which would place the tax preparer standard at the "substantial authority" level. A companion bill is expected to be introduced in the Senate very soon.

Lisa M. Dinackus is manager of congressional affairs on the AICPA's Congressional & Political Affairs Team. For further information on these legislative issues and congressional-related inquiries, write to 1455 Pennsylvania Avenue, NW, 10th Floor, Washington, D.C. 20004, e-mail ldinackus@aicpa.org, or call 202-434-9276.



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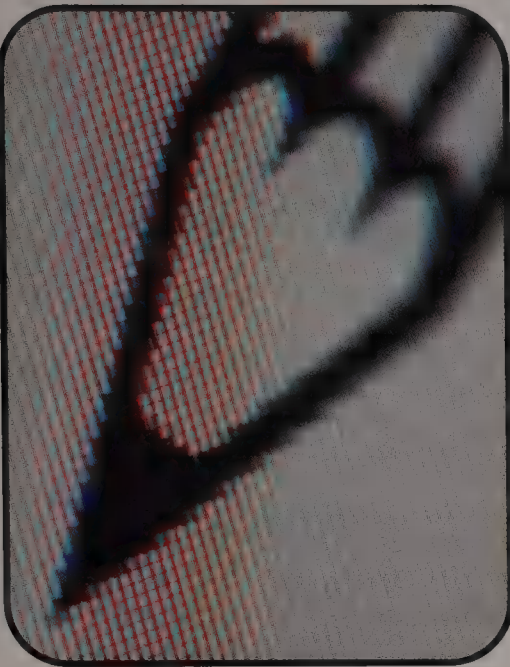
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CHECKLIST

Implementing Enterprise Risk Management



Managing risk is imperative for successful leadership in today's business world. Leaders must develop processes like enterprise risk management (ERM) to improve their ability to manage risks effectively. ERM cuts across an organization's silos to identify and manage a spectrum of risks. Consider these ERM action items:

- ✓ **Resolve to proactively manage risks,** rather than react to them. Implementing ERM takes total commitment by management, as well as recognition by the board of its responsibility.
- ✓ **Clarify the organization's risk philosophy.** As discussed in the COSO ERM framework (*Enterprise Risk Management—Integrated Framework*), organizations need to know their risk capacity in terms of people capability and capital. The board and management must come to an understanding, factoring in the risk appetite of all significant stakeholders.
- ✓ **Develop a strategy.** Since risk relates to the events or actions that jeopardize achieving the organization's objectives, effective risk management depends on an understanding of the organization's strategy and goals. One of the benefits of ERM implementation is the revelation that those re-

sponsible for achieving the objectives have varying degrees of understanding about them. ERM helps get everyone on the same page.

- ✓ **Think broadly and examine carefully events that may affect the organization's objectives.** This involves taking your business and industry apart. Pore over your strategy, its key components and related objectives. Use a variety of identification techniques such as brainstorming, interviews, self-assessment, facilitated workshops, questionnaires and scenario analyses. In selecting among these techniques, consider how rigorously each business unit can implement them, and if openness among the participants would result. Analyze how both external and internal events can change the organization's risk landscape. This initial effort does not have to take months to accomplish. Start with a top-down approach. Begin to identify risks through workshops or interviews with executive management and by focusing on strategies and related business objectives.
- ✓ **Assess risks.** Initially, try to reach a consensus on the impact and likelihood of each risk. Placing risks on a risk map can be a valuable focal point for further discussion. As the risk assessment process matures, consider applying more sophisticated risk measurement tools and techniques.
- ✓ **Develop action plans and assign responsibilities.** Every risk must have an owner somewhere in the organization. Manage the biggest risks first and gain some early wins.

- ✓ **Maintain the flexibility to respond to new or unanticipated risks.** Put a business continuity and crisis management plan into place. If your organization is in a volatile environment, you should anticipate even more unknowns.
- ✓ **Use metrics to monitor the effectiveness** of the risk management process where possible.
- ✓ **Communicate the risks identified as critical.** Circulate risk information throughout the organization. The board of directors and audit committee should be given regular reports on the key risks facing the organization. It is not acceptable to identify important risks and never communicate them to the appropriate people.
- ✓ **Embed ERM into the culture.** Integrate the knowledge of risks in your internal audit planning, balanced scorecards, budgets and performance management system. Leverage your organization's compliance with SOX section 404 to benefit ERM implementation. The focus by PCAOB Auditing Standard no. 5 and the SEC's new management guidance on "top-down" risks provides an opportunity to leverage compliance to enhance shareholder value through ERM.

—By **Paul L. Walker**, CPA, Ph.D., associate professor of accounting at the University of Virginia, and **William G. Shenkir**, CPA, Ph.D., professor emeritus at the University of Virginia. Their e-mail addresses are, respectively, pw4g@virginia.edu and wgs2z@virginia.edu. The authors have taught ERM for businesses and executives worldwide. They have co-authored three books on ERM and have consulted with COSO on ERM framework.

SMART STOPS

On the Web



SMALL BUSINESS

SOX ASSISTANCE

www.sec.gov/info/smallbus/404guide.shtml

This site features content from the SEC's *Sarbanes-Oxley Section 404—A Guide for Small Business*, a publication for small public company managers and their auditors as they begin to assess internal control over financial reporting. Sections such as "What Constitutes Effective Internal Controls?," "Identifying Financial Reporting Risks and Controls That Address Them," and "Do Your Controls Work in Practice?" guide small business managers through the assessment process for the first time. The complete guide is also available in a printable version.

FOCUS ON SMALL FIRMS

<http://pcps.aicpa.org>

Visit the AICPA's PCPS Firm Practice Center for the most recent installment of *Small Firm Solutions*, a new e-newsletter for small firms and sole practitioners. The quarterly publication, part of the Institute's "Small Firm Advantage" initiative, features "Hot Topics for Small Firms" from James Metzler, CPA, AICPA vice president—Small Firm Interests. The site hosts a collection of helpful resources from the Small Business Administration on startup businesses and on managing existing businesses. PCPS members can also access the "Risk

Assessment Standards Toolkit" for SAS nos. 104–111, as well as small firm marketing brochures.

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GENERAL INTEREST

WORD OF MOUTH

www.automatic-referrals.com

Written by Miriam Lawrence, director of Horsemouth, a business-building resource for financial advisers, the site provides tactics and tips for professionals

who use referrals for business development and growth. Find articles such as "Five Great Times to Ask for Referrals" and "Keep a Referral Scorecard," or catch up on Lawrence's "ABCs of Automatic Referrals" series, which starts with "A is for Action" and works through the alphabet, including "K is for K.I.S.S. (Keep It Simple and Specific)." The site also touches on topics such as client service and relationships, marketing and communicating value.

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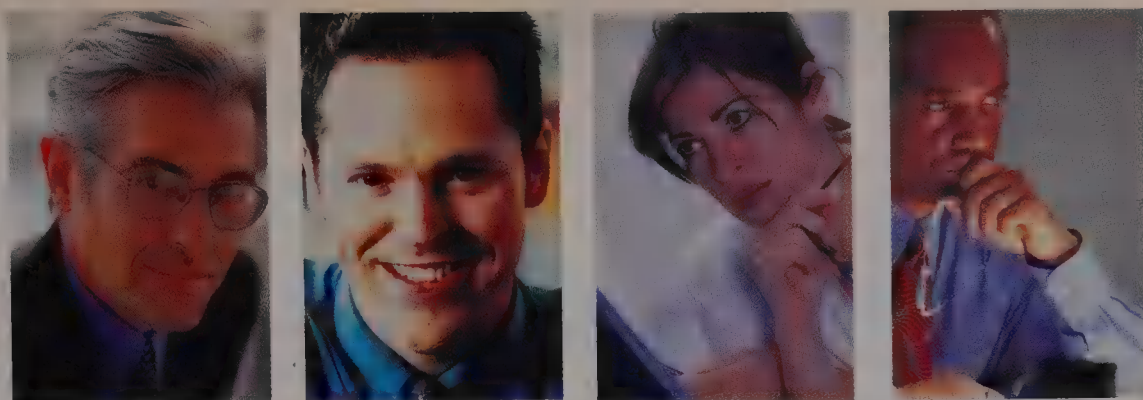
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GETTING A CLUE

<http://10qdetective.blogspot.com>

The mission statement says it all: "It is the job of the 10Q Detective to dig through businesses' 8-K and 10-Q SEC filings, looking for financial statement 'soft spots.'" The blog, run by David Phillips, a financial statement analyst, features several posts a week, including investment news, opinions, trading alerts and stock alerts. There are also links to financial Web sites, corporate governance news, educational sites and other investment-related blogs.

—Megan Pinkston



New...

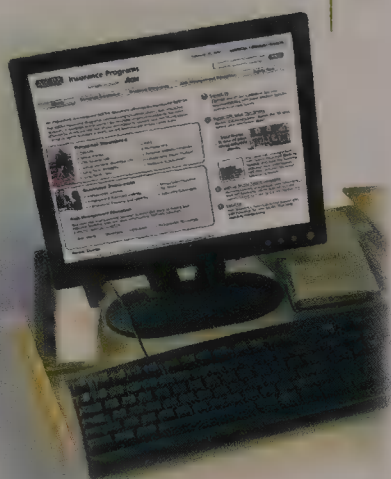
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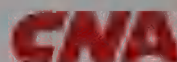
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Assisting Troubled Business Clients: A Midsize Dilemma for CPAs

by William Y. Culbertson

Certain identifiable traits of financial distress are common to every troubled business, regardless of its industry or size. A thorough understanding of those traits is helpful in choosing a course of action. This article examines the anatomy of a turnaround from the perspective of practicing CPAs and explains why a privately held midsize company has the best chance of surviving when its outside CPAs actively participate in the solutions to its problems, even if the CPAs need to abandon their independence.

Often, when a *Fortune* 500 company gets into trouble and its stock price tanks, an investment banker is hired to "explore strategic alternatives," the CEO is replaced, and the rest of the story is on public display. When a "mom and pop" business gets into trouble, the choices are much more limited—sophisticated outside help is too expensive, the CEO is the business, and the end result usually gets buried in annual statistics about small business failures.

But when a midsize business gets into trouble and fails to take corrective action, eventually its bankers lose confidence in management and often require a turnaround specialist as a condition for credit renewal. Chances are that the company's independent accountants recognized the warning signs of financial distress more than a year earlier and, following the guidelines of Statement on Auditing Standards no. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, addressed the "substantial doubt" question using the same intrinsic skills and business analysis techniques that are essential to a turnaround.

Yet, in my experience, CPAs rarely offer to assist a troubled business client for two reasons: Either they aren't familiar with how a turnaround works, or they are reluctant to abandon their independence. However, whether they realize it or not, CPAs speak the language of turnarounds

and are frequently more qualified to assist a midsize business in financial distress, especially if the only alternative is a bank-recommended turnaround specialist. This article provides CPAs with the tools they need to understand and possibly assist clients with the turnaround process.

THE TURNAROUND CAMPAIGN—A COMMON-SENSE APPROACH

Turning around a troubled business takes more than reducing costs, increasing sales or restructuring debts, although CPAs already play a significant role in defining or assessing these problems. The classic management consulting approach to problem-solving is a three-phase process: Analyze the problem; plan a solution; implement the plan.

Modifying this approach to a turnaround campaign includes considering the common traits of financial distress discussed above and adding two more phases to the process. The five phases of the process, presented below, each carry a suggested role for the CPA. There is overlap between them in terms of goals and timing. Therefore, the solutions, like the problems they address, must also be interrelated.

PHASE 1: INITIAL ASSESSMENT (IA)

The first step is a blunt analysis of the company's business model, assumptions underlying it, current conditions, and top management's effectiveness, which defines the problems and serves as a benchmark for future corrective action. The primary goals of this phase are to determine whether man-

Common Traits of Financial Distress

Individual warning signs usually appear in the numbers well before conditions reach a crisis stage, and an effective leader will recognize those that threaten the business. But, by the time a trend has developed or when warning signs appear in combinations, rather than isolation, chances are that financial distress has already arrived and brought with it questions about leadership.

There are two common categories of financial distress:

1. Early warning signs. Look beyond the numbers, whenever a warning sign appears, to properly identify the underlying cause-and-effect relationships. For example:

- A revenue decline could indicate a tough new competitor has taken away market share, a major customer relationship has been damaged or the overall market has declined.
- Aggressive price-cutting could cause a squeeze on margins but could also be due to supplier cost increases, operating inefficiencies or a high ratio of fixed-to-variable costs.
- Deterioration of receivables aging could reflect late deliveries, customer cash flow problems, or delivered quality faults.

Experienced CPAs, whether performing routine audit, accounting or tax services for a midsize business, will recognize these and other indicators. Of course, each sign could be an aberration and would not be significant standing alone. However, the longer the numbers are ignored and underlying conditions deteriorate, the worse the odds are for achieving a successful turnaround.

2. The leadership question. A turnaround may be the most difficult transition a company goes through. It requires decisive and confident leadership and a willingness to change. These attributes are often noticeably absent under distress. Instead, the following traits are consistently found:

- Management has lost sight of the company's core strengths or lost touch with changing times.
- Incumbent managers tend to resist change or underestimate how bad things can get.
- Management loses key stakeholders' confidence, both externally (bankers, customers and suppliers) and internally (employees, shareholders and management itself).
- Management time is in short supply when it is most in demand, leaving important matters unattended.

These two categories of common traits are interrelated and an important insight into the anatomy of a turnaround. Top management is usually part of the problem and needs outside assistance to interpret the meaning behind the numbers, regain its bearings, restore confidence, and execute a turnaround.

EXECUTIVE SUMMARY

■ **Experienced CPAs will often recognize early signs of financial distress** when performing routine audits, accounting or tax services for a midsize business.

■ **A turnaround requires decisive and confident leadership** and a willingness to change. Top management is usually under stress at this point, requiring outside assistance to interpret

the meaning behind the numbers, regain its bearings, restore confidence and execute a turnaround. CPAs may be the best qualified to offer assistance.

■ **CPAs have specialized training and education**, practical experience in examining business operations and assessing control environments, and have established relationships with their clients. These are intrinsic

skills necessary to helping with a turnaround.

■ **Follow this five-step process** to conduct a turnaround: (1) Initial Assessment; (2) Planning; (3) Execution; (4) Stabilization; and (5) Fresh Start.

■ **CPAs have a duty to protect the public interest** when they attest to financial statements. If a CPA's independence has been impaired by helping a client in a

turnaround, future attestation engagements must be performed by others. The client may still be an important source of referrals.

William Y. Culbertson, Esq., CPA, MBA, is an associate professor at Northern Kentucky University's College of Business. His e-mail address is culbertsonw@nku.edu.

agement is able to articulate a clear, well-conceived business strategy that works for the company regularly, and to answer the threshold question: Can the company survive? This step typically takes two to four weeks.

The CPA's role. This is similar to the requirements of SAS no. 59, but looks closely at management as part of the assessment process, much like the new going-concern standard currently under development by FASB. This is the most important service the CPA can first perform in assisting a troubled client. The threshold question is objective and not based on the subjective view of any single stakeholder, owner or banker.

If the CPA believes that top management is ineffective or that liquidation is likely, then do not expend resources on a lost cause. It is unlikely that assisting a client in this phase will impair the CPA's independence since the CPA will only be providing the client with his or her recommendations and not making the ultimate decision to expend the resources to turn the company around.

Practice Tip 1

► **The CPA's viewpoint is the most objective.** This is important during an Initial Assessment. Banks want to get repaid and owners tend to be desperate.

One of my biggest mistakes in a turnaround engagement with a nonattest client was to allow a wealthy owner, who had financed a \$20 million disaster with subordinated notes and personal guarantees, to postpone badly needed debt restructuring until after the turnaround had taken hold.

Although we were successful in attracting significant amounts of new capital and new business, the owner had privately hatched a "self-help" plan with the bank that derailed the entire process and ultimately spawned a number of lawsuits. CPAs should never subordinate their judgment about the feasibility of a turnaround.

Practice Tip 2

► **Legal counsel may be your greatest ally.** CPAs are usually surprised to learn that lawyers have a professional responsibility to approach management of a troubled business and to make recommendations beyond narrow legal terms, perhaps even where advice is unwanted.

Not only do their ethics rules suggest that lawyers should try to overcome management's resistance to change in such circumstances, they also state that lawyers should recommend consultation with accounting professionals or financial specialists when business matters involve problems within their domain. (ABA Model Rules of Professional Conduct, Rule 2.1, Comment 4.)

PHASE 2: PLANNING

If the threshold analysis concludes the company has a fighting chance for survival, develop a detailed corrective action plan based on the IA findings and form a turnaround team to oversee its implementation. Keep plans simple to establish a clear sense of direction and begin to restore confidence in leadership. This step typically takes one to three months.

The CPA's role. I believe the best turnaround teams are composed of the CPA, top management and legal counsel. Once this team is formed, they should satisfy themselves that the turnaround team has the knowledge and insight to address critical issues and the commitment to see the process through.

At this point it should be determined what the CPA's role will be. Will the CPA continue as an adviser or become part of the decision-making team? Of course, whenever CPAs become part of the decision-making team (my preference), their independence will be impaired from that point forward.

Once the team has been formed, its ini-

tial focus is to develop corrective action plans and to select the best metrics for measuring performance. For example, the turnaround team will set targets for fixed-, variable- and hybrid-cost components that must be achieved for the company to operate above its break-even point. The same holds true in setting goals for debt restructuring based on underlying collateral values and debt-service capability. Assisting in developing the corrective action plan and recommending metrics should not impair the CPA's independence unless he or she becomes part of the decision-making team.

PHASE 3: EXECUTION

This phase employs two concepts:

(a) **Divide-and-Conquer**, accomplished by outsourcing extraordinary problem resolution so management can concentrate on controlling ordinary ongoing operations. The goal is to restore internal confidence by overcoming the critical shortage of management's time and assuring that things don't get worse.

(b) **Before-and-After**, meaning that the bottom line must be sacrificed to improve the company's cash position (the "before") in order to reach the targets established during the planning phase (the "after"). This allows the company to walk a tightrope from

Practice Tip 3

► **First, do no more harm.** If top management is unable to maintain important daily activities without matters getting worse, in spite of the fact that additional outside resources have been brought to bear in the Execution phase, then either the threshold question was answered incorrectly in the IA phase, or top management is not up to the task or does not represent the best interests of the company.

Although it's possible to turn around a troubled business while replacing top management, it's more difficult, requires a different approach, and is beyond the scope of this article.

Practice Tip 4

► **Get paid for such extraordinary work.** CPAs who are willing to step forward and assist clients in distress should require a replenishing retainer, just like a turnaround specialist would.

Of course, troubled businesses are already strapped for cash in most cases, but this objection should be easy to overcome by discussing priorities and pointing out that administrative fees are always paid near the top of the list of every Chapter 11 proceeding. Administrative costs associated with an informal restructuring like a turnaround are almost always less than a formal reorganization, but are just as important.

Moreover, the prospect of becoming a substantial unsecured creditor is hardly conducive to maintaining objectivity. CPAs who perform such a valuable service for their clients under demanding circumstances should expect to get paid for it in the ordinary course of business or, without exception, they should decline the engagement.

short-term survival to long-term viability without reaching the tipping point, by overcoming the other critical shortage (cash). This step can take one to 12 months.

The CPA's role. The CPA should remain involved throughout the Execution phase. Whether the CPA chooses to be hands-on in helping to resolve extraordinary problems, or oversees a specialist brought in for that purpose, will likely depend on the precise problems and the client's wishes. For example, while management is tending to major customers, supply chain issues and labor relations, the CPA (or specialist) can fend off threats, carve out non-essential assets, resolve disputes and/or negotiate standstill agreements.

On an ongoing basis, the CPA can help top management stay focused on what works, avoid what doesn't, and fine-tune

the performance metrics as needed, based on the insight gained during the IA phase. The key to solid execution and restoring confidence is being available to assist where needed and staying sincerely committed to the process. It is most likely that any involvement by CPAs in the Execution phase will compromise their independence.

PHASE 4: STABILIZATION

This phase demonstrates that progress must be steady and sustainable. The primary goal is to restore confidence of external stakeholders, which means that internal stakeholders shouldn't attempt to undertake growth strategies before stability has been established. A turnaround takes time, and bankers won't believe it until they've seen it twice. This step takes one to two years.

The CPA's role. Most CPAs have extensive experience acting as liaisons between business clients and important creditors or investors. This role is important after the turnaround has taken hold. The CPA can keep communication channels open and hopefully avoid "lender fatigue" that often affects relationships between a troubled business and its bankers. If the independence line was crossed earlier in the process, there is no going back at this phase; if not, CPAs should limit their communication with creditors during a turnaround campaign that is being executed by others, so as not to appear to be reporting on behalf of management.

PHASE 5: FRESH START

This phase recognizes that money follows solutions. A turnaround is about retrenchment, not growth, because it's hard for a business to grow its way out of trouble. Once the turnaround is complete and confidence is restored internally and externally, revisit business strategy based on lessons learned from the past. This step is typically reached after about two years.

The CPA's role. Who better to help the company chart a new course than the CPA who participated in the turnaround? Clients typically discover that the ingredients of a successful turnaround campaign provide valuable insights into the strategic direction and guidance needed for long-

term prosperity. Moreover, in establishing a new business model, that client is likely to need help finding new sources of capital and the CPA should be able to tell a compelling story.

The CPA can do many things in a turnaround campaign to assist a client-company without stepping into management's shoes. In those cases where the CPA's independence has been impaired due to the role played in a successful turnaround, future attestation engagements must be performed by others.

But when should CPAs be willing to abandon their independence by assisting troubled business clients? Why not leave it to the turnaround specialist instead?

WHY CPAs SHOULD HELP

One of the worst things that could happen to a client-company with a fighting chance for a turnaround and who recognizes the need for change is to be forced to choose a specialist from a banker-provided list. The bank will expect to be kept informed by the specialist; management may distrust them; and some turnaround specialists who work for banks tend to "tee-up" assets for bulk sale. That's a liquidation, not a turnaround.

Practice Tip 5

► **Beware of predators.** I have learned from experience that some turnaround specialists may look for opportunities to liquidate for profit, perhaps because their interests don't truly lie in saving the business.

In addition, private equity groups may be willing to provide fresh money at a steep price, which could result in a backdoor takeover. I encountered one specialist who put these two approaches together and managed to take over a midsize business without putting any capital at risk, while charging a management fee for the privilege.

In fairness, a variety of professionals offer this kind of service. An Internet search turns up management consultants whose Web sites display impressive resources and credentials.

However, turning around a troubled business requires a level of commitment based on some degree of loyalty to the company. Moreover, many of these professionals are no match for the reputation, experience or competence of CPAs, plus CPAs already have an established relationship with, and insight into, the business.

Nevertheless, a major issue for CPAs tends to be the appearance of independence, which is best understood as a CPA's duty to the public. CPAs must balance their duty to protect the public interest, whenever they have attested to financial statements, with their duty to the established client relationship.

Concerns about maintaining independence for the sake of rendering future opinions should be set aside in favor of the

exigencies of the day, because saving the company and losing an audit client is better than the alternative. Moreover, the client that is saved today but relinquished tomorrow to another firm might prove to be an important source of referrals.

CONCLUSION

In my 30 years working with a number of companies in financial distress, I have often heard clients express frustration that their outside accountants raised the going-concern question but never offered to assist. CPAs don't need to be experts in business turnarounds, but before their client's fate is sealed, they should at least understand the process and offer to consult with a troubled business client whenever a turnaround specialist is brought in for that purpose. Hopefully, this overview of a turnaround campaign will give CPAs greater insight into what to do when they find that a valued client has been engulfed by this predicament. The general public and clients, in par-

ticular, will benefit if CPAs use their intrinsic advantages vital to the moment. ♦

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JofA articles

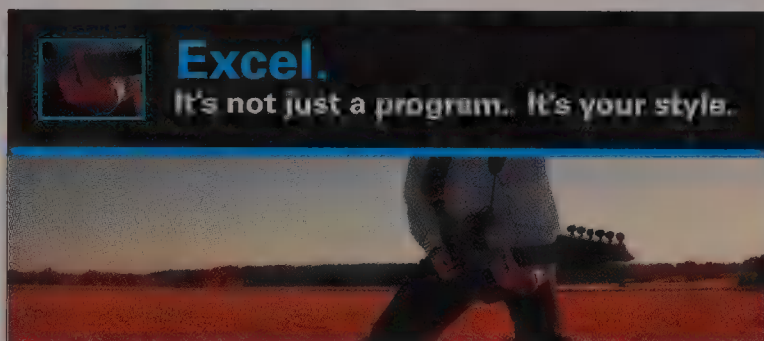
- "Deepening Insolvency," Feb. 08, page 40
- "Ethics Rules Get Tighter," Dec. 06, page 59
- "CFOs for Hire," April 03, page 35

OTHER RESOURCES

- Association of Certified Turnaround Professionals, www.actp.org
- Association of Insolvency & Restructuring Advisors, www.airacira.org
- American Management Association, www.amanet.org
- Turnaround Management Association, www.turnaround.org
- *Reorganizing Failing Businesses*, Volumes 1 & 2, Weil, Gotshal & Manges LLP (<http://www.amazon.com/Reorganizing-Failing-Businesses-Volumes-2/dp/1590317149>)

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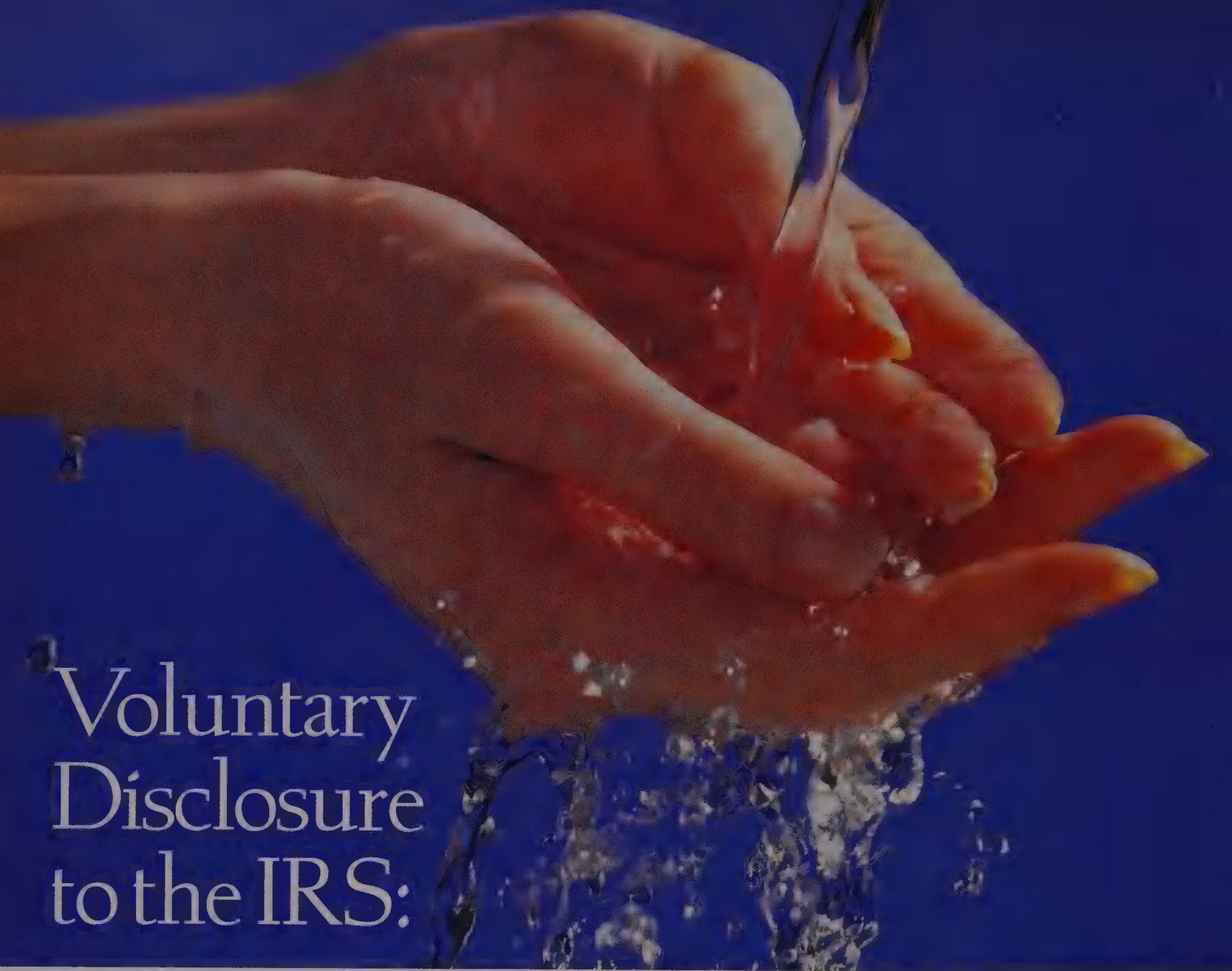
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Voluntary Disclosure to the IRS:

A Viable Option

While failure to file returns or pay correct tax can subject clients to heavy penalties, taxpayers who come forward can sometimes receive a break.

by Stephen G. Huggard

Every once in a while, a client with a heavy heart visits a CPA. The client has not been paying what he or she owes Uncle Sam and wants or needs to come clean, but has no idea how to do so. The good news is that there are ways to help your client.

For more than 55 years, the IRS has had a policy that can allow such taxpayers to come forward and, in exchange for their

truthfulness and cooperation, escape criminal prosecution. While the Service's forbearance under this voluntary disclo-

sure policy is not ironclad or available under all circumstances, it can be determinative. "A true voluntary disclosure is usually the deciding factor in decisions about prosecution," said Shirley D. Peterson, former IRS commissioner, in a speech to the AICPA Tax Division.

The bad news is that inexperienced advice can buy the client a lot of trouble, perhaps even a stay in a federal penitentiary. CPA tax practitioners who learn of an error in a taxpayer's return or the taxpayer's failure to file a required return should advise the taxpayer of the error and measures to be taken. In keeping with AICPA Statement on Standards for Tax Services (SSTS) no. 6, if it appears the taxpayer could be charged with fraud or other criminal misconduct, the taxpayer should be advised to consult legal counsel.

CRIMINAL PENALTIES POTENTIALLY SEVERE

The U.S. punishes tax evasion more harshly than most countries. While anecdotal evidence suggests that many more people cheat on their taxes every year than are caught by the IRS, those who are caught can be punished far more severely than the public might realize. Federal sentencing guidelines call for someone who evades between \$30,000 and \$80,000 in taxes to be sentenced to between 15 and 21 months in prison, without benefit of parole. In addition, the taxpayer will still owe the back taxes, interest and penalties. Many Americans live with the fear that the IRS somehow will find out the truth about their tax returns. That fear can be paralyzing but need not prevent a client from addressing the issue head-on.

The IRS can be relatively forgiving if taxpayers voluntarily disclose that they have not reported all their income or have not filed all their tax returns. In fact, the Service's policy encourages people to voluntarily disclose their tax delinquencies in return for consideration from the IRS in determining whether criminal charges should be sought. The back taxes and interest, however, will have to be paid in full. This is good for the IRS, which after all is in the business of collecting money. Almost anything that encourages more people to pay more money is good for it.

But why would an individual ever make such disclosures? And what does "relatively forgiving" mean? In answer to the second question, a successful filing of a voluntary disclosure may result in criminal prosecution not being recommended, as long as it's

not subsequently determined the taxpayer was untruthful or uncooperative.

Taxpayers may want to get right with Uncle Sam for several reasons. Some people are bothered by their consciences. Others are refinancing mortgages and need to show accurate tax returns to the lender. People may become embroiled in a nasty bit of litigation with someone who knows their secret, and they want to remove the leverage that such knowledge provides the opposing side. Maybe they are changing marital status. In any event, they have come to realize that a criminal prosecution is at least theoretically possible, and they want to eliminate the threat from their lives.

WHEN DISCLOSURE IS VOLUNTARY

Unfortunately for such people, the IRS's voluntary disclosure policy contains some strict guidelines. The Internal Revenue Manual (IRM), which establishes policies and guidelines for IRS agents nationwide, makes it plain that the disclosure must be both voluntary and timely before the IRS will consider it favorably (IRM section 9.5.11.9). In addition, the taxpayer must show a willingness to cooperate with the IRS in determining his or her correct tax liability and make good-faith arrangements to pay all outstanding taxes, interest and applicable penalties. The taxpayer does not have to file complete returns and make full payments at the time of the voluntary disclosure; he or she just has to make the IRS comfortable that both will happen.

The disclosure must be made before the

taxpayer has come to the attention of the IRS through independent means. If the taxpayer is the subject of a civil or criminal investigation by the IRS—even if the taxpayer does not know it—it is too late to make a voluntary disclosure to the IRS. If the taxpayer's tax issues have been brought to the attention of the IRS through a third party such as an informer or the media, it is too late. This category of "informants" includes the taxpayer's bank. If the taxpayer deals with large amounts of currency, the bank may well have filed Currency Transaction Reports or Suspicious Activity Reports with the IRS. The IRS considers these reports on a par with informants. Conversely, if the IRS is examining a widely promoted scheme in which the taxpayer participated but the taxpayer himself or herself has not yet come to the attention of the IRS, the disclosure still may be timely.

The voluntary disclosure should be made to the Criminal Investigation office of the IRS and is best made to a supervisory special agent, since it will be evaluated by a special agent. There are hazards. The IRS goes out of its way to underscore a lack of guarantees in this area. Specifically, there is no guarantee that, just because the taxpayer discloses to the IRS, that the IRS will not seek to prosecute the taxpayer. Therefore, before any disclosures are made, a representative must carefully debrief the taxpayer to ensure that there are no issues that the IRS will already have on its radar. This should be done by a qualified attorney, to cloak the conversation in the attorney-client privilege. Clients may well be

EXECUTIVE SUMMARY

■ **Under its policy of voluntary disclosure**, the IRS can forbear from referring for criminal prosecution taxpayers who come forward to admit previously unreported tax liabilities. CPAs may be in a position to learn of clients' intentions to make such disclosures. Where disclosures could otherwise entail criminal penalties, CPAs should refer clients to a qualified attorney in keeping with AICPA Statement

on Standards for Tax Services no. 6 and for the attorney-client privilege available.

■ **Policies and guidelines for voluntary disclosure** are contained in Internal Revenue Manual section 9.5.11.9. To take advantage of them, taxpayers must be willing to cooperate with the IRS in determining correct tax liability, which they must arrange to pay, along with interest and penalties.

■ **Voluntary disclosure treatment is not available** if the IRS has learned of the taxpayer's liability through the news media, an informant, bank reporting or the fruits of its own investigation. Also, voluntary disclosure does not protect a taxpayer whose unreported income was from an illegal source.

■ **Despite its potential pitfalls, a properly managed voluntary disclosure** may be a valuable

strategy for taxpayers who otherwise could face severe penalties that can in some instances include incarceration.

Stephen G. Huggard, Esq., is a partner in the Securities, Government Enforcement & Corporate Governance Litigation practice group of the 550-attorney international law firm of Edwards Angell Palmer & Dodge. His e-mail address is shuggard@eapdlaw.com.

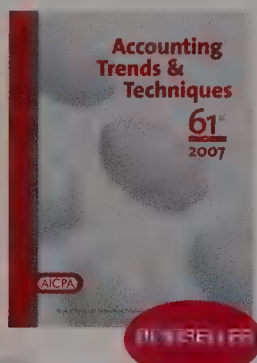
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loath to admit in a nonprivileged setting some aspects of their activities that have come to the Service's attention.

In the debriefing of the client, before any disclosures are made, counsel will best be able to determine whether the taxpayer has engaged in activities that are likely to be known to the IRS. If the IRS decides that the information is not new to it, agents will listen politely and then use that information against the taxpayer, who will have dug a hole from which he or she may never emerge.

Among other things, counsel must ensure that the unreported income was all "legal source" income—money made from lawful dealings. Dealers in illegal drugs, for example, cannot benefit from the voluntary disclosure policy. The taxpayer must also be willing to disclose all entities that are related to him or her. For example, if he or she owns a string of restaurants, each separately incorporated, the IRS will expect him or her to identify each and to make sure that each set of returns is up to date and accurate.

This is not the time to be cute with the IRS. If it decides that the taxpayer has been only partially forthcoming, it is likely to view him with suspicion and pursue any remedies it has, including criminal investigation. The IRS expects that people who seek shelter under the voluntary disclosure policy will be fully forthcoming. At the same time, the risks involved argue in favor of having the communications come through the taxpayer's counsel, and not from the taxpayer.

AN "ALL-IN" PROPOSITION

Anonymous disclosures are counterproductive. The IRM explicitly states that anonymous disclosures are insufficient to warrant favorable consideration by the IRS. Moreover, the anonymous disclosures can prompt the IRS to begin an investigation, thus precluding the possibility of the taxpayer ever being able to voluntarily disclose his or her issues. The taxpayer will effectively have become a "third-party" informant against himself. Taxpayers who think they want to disclose to the IRS must understand that this is an "all-in" proposition; they do not get to stick their toe

in the pool to test the waters. That being said, the representative might well want to have some exploratory talks with the IRS in which the situation is described to gauge the agents' reactions, with the understanding that until the taxpayer's identity is disclosed, nothing really has happened and no protections can be expected.

As with most policies, some gray areas in the voluntary disclosure policy should be explored with caution. For example, the IRM specifically states that the disclosure is not timely if the IRS has received information about the taxpayer through a criminal enforcement action such as a search warrant or grand jury subpoena. It also states that a disclosure is not voluntary when made by a taxpayer who is under grand jury investigation. The IRM does not specify that the grand jury investigation has to be tax-related to foreclose the disclosure. In fact, many grand jury investigations uncover tax issues that are never shared with the IRS.

Given the tenor of the IRM, that the disclosure is too late if the IRS already knows about the taxpayer's issues, the disclosure might (arguably) be considered timely and voluntary even if the taxpayer is a subject of a grand jury investigation being conducted by a different agency. This is not plain, however, and is a good example of the type of scenario counsel might want to present in a preliminary fashion before disclosing the taxpayer's identity.

Once the disclosure is made, a special agent will evaluate it. If the agent deems it to be truthful and complete, he or she will so indicate to the special agent in charge. According to the IRM, the evaluation should be completed within 10 working days from when it was received. The disclosure doesn't have to be communicated in any particular format, but processing it will require information outlined in IRM 9.5.11.9.6.

If the IRS accepts the disclosure, it is agreeing to take it into consideration in deciding whether to recommend prosecution by the Justice Department. If all other factors are met, the disclosure may result in prosecution not being recommended.

HAZARDS MANAGEABLE

For many CPA firms, apparent criminal exposure for their tax clients may come up seldom, if ever. "Thankfully, our firm does not have much experience with voluntary disclosure," said Patrick H. O'Brien, a CPA with O'Brien, Riley & Ryan PC in Westwood, Mass. "We require our clients to provide us with the information necessary to file complete and accurate returns. In situations where clients come forward with information indicating that they have been less than truthful in the past, it becomes necessary to carefully reconsider whether that client relationship still makes sense."

"If we decide to continue our relationship with the client, we first encourage that the client immediately retain legal counsel," O'Brien said. "After the client and his legal counsel have reviewed all their options, we do believe that the use of voluntary disclosure is a viable option that should be considered and could provide significant savings to the client. Most likely, we may use the voluntary disclosure with a new client or referral that is looking to get back on the right track."

There are generally few risks to the CPA if the client makes a properly counseled voluntary disclosure. If the IRS accepts the disclosure, it would not be very interested in the accountant's role in any prior filings. Of course, if the accountant knew of and participated in prior filings of false tax returns, it would be potentially problematic to have the client talking to the IRS. In most cases, however, any involvement by the accountant would be sufficiently innocent that the

IRS would not take an interest.

Given the hazards built into the voluntary disclosure policy, is it ever wise to pursue a disclosure? These days, in particular, the answer is "yes." Law enforcement resources are stretched thin, and with the Justice Department focused on terrorism, the IRS is often happy to get a taxpayer back in the fold without having to launch an in-

vestigation. The taxpayer must simply be aware of the rules and be candid with counsel about his or her situation. While there are no guarantees, practice reveals that properly made voluntary disclosures are usually effective. As long as the taxpayer is careful, he or she likely will wind up poorer but still free, which definitely beats poorer and in jail. ♦

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Are Your ESO Values on Target?

Valuing employee stock options for closely held companies

by Keith Sellers, Yingping Huang and Brett A. King

Until recently, non-public companies that granted options, warrants or other types of stock-based compensation to their employees were not typically required to determine values for these complex derivative instruments. Current financial reporting standards such as FASB Statement no. 123(R), *Share-Based Payment*, as well as recent federal tax law changes (IRC § 409A) are compelling companies to value these financial instruments using stock option valuation models developed for publicly traded stock options.

But several issues are unique to the valuation of employee stock options (ESOs) for closely held companies. Even well-designed option valuation models will yield incorrect values if they are not modified to address these unique issues. These problems are not only a concern when the ultimate objective is to value ESOs. The failure to correctly value employee stock options can result in a material error in the appraisal of the underlying common shares.

OPTION VALUATION MODELS

Statement no. 123(R) does not prescribe a specific option valuation model. Rather, it states that “a lattice model (for example, a binomial model) and a closed-form model (for example, the Black-Scholes-Merton formula) are among the valuation techniques that meet the criteria required by this Statement for estimating the fair values of employee share options.”

However, the standard clearly states that the appropriate method to use depends on the “substantive characteristics of the instrument being valued.” Since ESOs include characteristics such as vesting schedules, anticipated employee turnover and the possible early/suboptimal exercise of the option, it is clearly more appropriate to use a lattice model that can incorporate these features.

The Hull-White approach is a lattice model that can be customized to fit virtually any option feature including the early exercise of options by employees, turnover and employee exit rates both before and after vesting, which can vary over the life of the option.

The model can incorporate suboptimal exercise assumptions (the conditions under which employees are expected to exercise their options in terms of the stock price reaching a specified multiple of the exercise price). Users can also incorporate historical or projected turnover and employee exit rate information into the model. Specifically, given an employee turnover rate, each node on the lattice contains a probability that the employee will exercise a vested option or forfeit an unvested option, depending on its probability of being "in the money" at that time.

EMPLOYEE SHARE OPTIONS—STOCK OPTIONS OR WARRANTS?

When a publicly traded call option is exercised, the owner of the call option receives an existing share from an assigned call writer. The writing and exercising of such options have no effect on the value of the underlying shares. All basic option valuation models, including lattice models, were "constructed" to value these non-dilutive, publicly traded options.

When valuing employee stock options, it is critical to understand that ESOs are more correctly identified as

warrants than options. Consistent with the financial literature, warrants are similar to call options, but the money (exercise price) goes to the issuer, not an option underwriter. When a warrant is exercised, the company issues new

common shares. Since the value of the underlying shares is a direct input in the valuation of any ESO, any change in the value of the underlying common shares will impact ESO values. Thus, the dilution simultaneously affects the value of

Through dilution, the issuance of ESOs will directly impact the value of existing common shares.

shares of stock, so the number of outstanding shares increases. In short, exercise of an ESO results in the issuance of new shares. Since by definition that issuance takes place at a price that is below fair value, ESOs dilute the value of common stock.

This dilution impacts the value of both the common shares of the company and its ESOs. For publicly traded companies, the dilutive effects are incorporated into observed market prices. However, this mechanism is not available for closely held companies that issue ESOs.

When valuing ESOs for a closely held company, CPAs must rely on an appraised value of common equity rather than an observed market-determined price. However, if the company has issued ESOs, this appraised value cannot merely be attributed to common shares. Rather, it must be allocated to both existing shares and all outstanding ESOs. Through dilution, the issuance of ESOs will directly impact the value of existing

both the common shares and ESOs. The interrelationship between stock and ESO value was addressed by FASB in paragraph A38 of Statement no. 123(R):

"[E]xercise of employee share options results in the issuance of new shares by the entity that wrote the option (the employer), which increases the number of shares outstanding. That dilution might reduce the fair value of the underlying shares, which in turn might reduce the benefit realized from option exercise."

To correctly account for these interrelationships, all new and existing ESOs and the common stock must be valued simultaneously. Since most option valuation models require stock value as an input (as opposed to an output), these models should be modified to let both stock value and ESO value be determined simultaneously, with fair value of equity being provided as an input.

EXECUTIVE SUMMARY

■ **Employee stock options (ESOs) more closely resemble warrants** than traditional options in that they result in the issuance of additional shares of stock. Like warrants, ESOs impact stock values because they are dilutive.

■ **To determine the value of ESOs for a closely held company**, first determine the fair value of common equity then allocate that value between

the common stock and the ESOs.

■ **The value of the options and the value of the common stock cannot be determined independently**, with the remainder simply being allocated to the other. Because the value of each instrument is a function of the other, their values must be determined simultaneously.

■ **The value of each of a com-**

pany's potentially dilutive instruments, including outstanding ESOs, warrants or convertible debt, must be included in the valuation of any new ESOs being granted.

■ **Because closely held companies do not have historical volatility data**, special rules apply when estimating expected volatility for these companies.

Keith Sellers, CPA/ABV, CVA, DBA, Yingping Huang, Ph.D., OCP, CISSP, and Brett A. King, Ph.D., serve on the faculty of the College of Business, University of North Alabama. Their e-mail addresses are kfsellers@una.edu, yhuang@gmail.com and baking@una.edu, respectively.

A Method for Partitioning Value

When valuing the common stock and ESOs of a closely held company, the appraised total value of common equity must first be determined using traditional business valuation methods.

This value must then be allocated between the various components of common equity, in this case common stock and ESOs. While this process is complicated by the fact that the value of each component is a function of the other component's value, one can assume that the correct value of the company's stock can be no less than zero and no more than the total value of common equity.

Using this information, the bisection method determines the midpoint of this interval and uses this midpoint as the stock price to calculate a value for the options. If the resulting sum of the option and stock values exceeds the total value of equity, the model understands that the midpoint value is too high. The model then discards values above the original midpoint, making the midpoint the top of the remaining interval of potentially correct stock prices. The model then uses the midpoint of the remaining possible stock prices and performs this procedure again.

Thus, with each iteration, half of the possible solutions are rejected. This process is repeated until the total value of the options and stock equals the total value of equity (within a specified tolerance, such as \$0.01).

The authors have developed a software package called the BVR/DVA 123R Compliance Calculator that uses the method described above. For more information, visit www.bvresources.com/123R.

The effects of these interrelationships on value can be demonstrated with the following examples. Assume that the value of common equity for a non-public company has been independently appraised at \$5 million and there are 100,000 common shares outstanding. In the absence of any ESOs, the stock would be worth \$50 per share.

Now assume that the company grants 10,000 ESOs with an exercise price of \$50 each. The options have a maturity of 10 years and the typical attributes and assumptions shown in Exhibit 1 are used to value the options.

Based on this information, the use of a typical Hull-White lattice model with 1,000 time steps yields an option value of \$27.75 per option. However, this value does not reflect the dilutive effect of the ESOs. Modifying the option valuation model to use a bisection method

(see sidebar "A Method for Partitioning Value") that *simultaneously* determines the optimal stock price and option value yields the results shown in Exhibit 2.

As can be seen, dilution materially reduced the per-share or per-option value of both the stock and the ESOs. For this reason, the value of both the stock and the options can only be determined simultaneously. This interrelationship of values extends to any additional ESOs, warrants or other dilutive instruments. For example, now assume the same company already has an additional 10,000 ESOs outstanding, which were issued five years ago with an exercise price of \$30. The appraised value of equity would be allocated as shown in Exhibit 3.

In summary, unless your option valuation model can simultaneously allocate values to stocks and all ESOs,

Exhibit 1

Current Stock Price:	\$50
Exercise Price of the Option:	\$50
Risk-Free Rate:	5.16%
Time to Maturity:	10 years
Stock Volatility:	50%
Dividend Yield:	0
Vesting Period:	3 years
Suboptimal Exercise Multiple:	2
Employee Annual Exit Rate:	3%

Exhibit 2

Equity Instrument	Per-Share or Per-Option Value	Total Value
Common Stock	\$47.73	\$4,772,550
New ESOs	\$22.74	\$ 227,450
Total Value of Equity		\$5,000,000

it will yield incorrect ESO values for closely held companies. This, in turn, will result in incorrect stock valuations. Statement no. 123(R) states that "employee share options and similar instruments will be estimated using option-pricing models *adjusted for the unique characteristics of those instruments*" (italics added). Clearly, any "off-the-shelf" option valuation model must be

ESTIMATING EXPECTED VOLATILITY

The need to partition value between shares and ESOs is not the only issue when valuing private vs. public companies. Volatility is a critical input in any option valuation model because a relatively small change in this estimate can result in a large change in the value of the option. Unfortunately, volatility

Exhibit 3

Equity Instrument	Per-Share or Per-Option Value	Total Value
Common Stock	\$45.72	\$4,571,705
New ESOs	\$21.48	\$ 214,795
Old ESOs	\$21.35	\$ 213,500
Total Value of Equity		\$5,000,000

adjusted to "incorporate the dilutive effects of ESOs.

A final relationship between employee stock options and stock values should be mentioned. While the appraised value of equity was held constant in the preceding examples, the existence of ESOs may very likely influence the appraised value of common equity. A primary purpose of ESOs is to help attract, reward and retain valuable employees. The use of ESOs may allow

can also be one of the more difficult variables to estimate since it requires a combination of empirical data, advanced statistical techniques and the use of professional judgment. The appropriate measure of volatility, referred to as "expected volatility" in Statement no. 123(R), is that which is expected during the remaining life of the option. Expected volatility is most often estimated using historical price data. In fact, Statement no. 123(R), paragraph

ESOs may allow a company to pay below-market cash compensation while reducing turnover and improving productivity.

the issuing company to pay below-market cash compensation while reducing employee turnover and improving productivity. In other words, while the issuance of ESOs will directly reduce stock values through dilution, the business appraiser should consider their potential impact on the amount, timing and uncertainty of future cash flows and other key variables affecting firm value.

A21, states that "Historical experience is generally the starting point for developing expectations about the future."

However, non-public companies have no historical price volatility by which to estimate expected volatility. For these companies, the standard provides two alternative sources of volatility information:

1. **Identify similar public companies.** If a company can identify similar public companies, it should consider the historical, expected or implied volatility of those public companies' shares to help estimate expected volatility.
2. **Identify an appropriate index.** If no similar public companies can be identified, one should identify and use the volatility of an appropriate industry or subindustry index (see example at paragraph A139 of Statement no. 123(R)).

In either case, one must exercise judgment in identifying either appropriate similar companies or an appropriate index. FASB has determined that the choice of estimating future volatility requires professional judgment that cannot be prescribed, so it is up to the individual performing the valuation to determine (and support) which data and approach is most appropriate for the specific options he or she is valuing. In all cases, Statement no. 123(R) cautions that companies should be consistent in this and all critical inputs. ♦

AICPA RESOURCES

JofA article

"How to 'Excel' at Options Valuation," Dec. 05, page 57

Conference

Fair Value Measurement Workshop, Feb. 28-29, New York City

For more information or to register, go to www.cpa2biz.com, or call the Institute at 888-777-7077.

OTHER RESOURCES

Articles

- "Accounting for Employee Stock Options: A Practical Approach to Handling the Valuation Issues," *Journal of Derivatives Accounting*, Vol. 1, No. 1 (2004), page 3
- "How to Value Employee Stock Options," *Financial Analysts Journal*, Vol. 60, No. 1 (Jan./Feb. 2004), page 114



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Allocating Value Among Different Classes of Equity

Valuation models can be tailored to unique financing structures.

by Andrew C. Smith and Jason C. Laurent

All companies with preferred stock need to be fluent in the application of an option-pricing method since it is often used to determine the per-share value of their common or preferred securities. An understanding of option-pricing models is no longer the exclusive domain of a small group of accountants. Now, board members, executive officers, CFOs, auditors and private equity investors should have an awareness and understanding of the option-pricing models.

Today, companies are being financed with hybrid forms of capital that go well beyond plain-vanilla common equity and interest-bearing debt. It is not unusual for a business to carry debt that can be converted to equity or equity that is entitled to a liquidation preference. To complicate matters further, some rounds of financing incorporate caps, accrued dividends, performance warrants and other valuation complexities. An understanding of these financial structures and their effect on value is essential for several interested parties:

- **Valuation analysts** need to understand the ramifications of a company's capital structure on the value of its equity securities.
- **Executive management** needs to know the effect that a round of financing may have on the fair value of a company's existing securities and capital structure.
- **Private equity investors** need to understand the effect that their invest-

ment has on the fair value of other equity securities in order to better structure their transactions.

Accordingly, we have presented an example to help valuation analysts, senior executives and investors through the structured-finance maze.

ALLOCATING EQUITY VALUE BETWEEN DIFFERENT CLASSES OF EQUITY

In 2004, the AICPA released its Practice Aid titled *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (please note that due to changes made to professional standards since this practice aid was originally issued, it is out of print and no longer available for purchase through the AICPA Web site). The guide summarizes many of the valuation standards and procedures that have been adopted by the profession. The guide also describes three methods of allocating value between preferred and common equity, which include:

- Current Value Method ("CVM")
- Probability Weighted Expected Return Method ("PWERM")
- Option-Pricing Method ("OPM")

The CVM has practical limitations on its use. Specifically, it should be used in two cases: (1) when a liquidity event is imminent and (2) when the business is at such an early stage of development that there is no material progress on the company's business plan and there is no reasonable basis to estimate value beyond the preferred preference.

The PWERM is especially difficult to apply due to the significant level of subjectivity it requires. The probability of various exit scenarios and the value of the business at such exit events is very difficult to support.

As a result, the OPM is a commonly used method for allocating equity value between common and preferred shares. The OPM is more quantitative as it relies on the Black-Scholes-Merton model. Although the Black-Scholes formula was not designed for private companies, the accounting profession applies it in various situations, ranging from stock options to common equity valuation, and it continues to be the basis for the OPM.

OVERVIEW OF KEY STEPS FOR THE OPTION-PRICING METHOD

Below, we have summarized the steps and general processes in applying the option-pricing method.

Step 1—Determine Business Value and Black-Scholes Assumptions

- **Business Value**—As the OPM values invested capital as a call option on a company's value, the analyst must

first determine which value to use. Conceptually, this value should be the amount claimholders would receive in a liquidity event. Accordingly, it is reasonable to estimate this value by using the implied enterprise value derived from the market-based and income-based analyses as of the valuation date. Since the fair value of interest-bearing debt (net of excess cash) is typically known, it can be subtracted from enterprise value.

- **Time to Liquidity Event**—This is one of many assumptions that can be difficult to pin down, but the question that it raises is a significant one: How much time exists until there is a planned or likely liquidity event, such as a sale, public offering or other exit event? Of course, no company has a crystal ball and many professionals are often frustrated trying to defend the assumption. Interaction at the board level is often warranted.

- **Risk-Free Rate**—The risk-free rate is the most obvious assumption. Typically, it is the rate available on a government security whose term matches the assumed time to liquidity. The analyst must then compute a continuously compounded equivalent rate for the Black-Scholes calculation.

- **Volatility**—This measure should be based on the standard deviation of quoted market prices. In the case of a public company, volatility can be derived easily from the company's historical stock prices. For private

companies, volatility can be estimated by analyzing comparable public companies' historical stock performances. It should be noted that the range of the stock returns sampled should cover the same period as the estimated time to liquidity. The OPM is highly sensitive to volatility and great care should be taken in estimating the volatility factor.

Step 2—Understanding the Capital Structure

Convertible debt and preferred stock come in many flavors, shapes and sizes. It is critical to invest the time to properly understand any conversion features. For example, some private equity firms structure preferred rounds that are effectively debt but labeled as preferred stock for tax purposes (the preferred never converts, instead it simply accrues a dividend). Whereas, other more common preferred rounds may have a choice of both realizing their preferences and then participating with common shareholders. Other preferred stock may be structured to either convert to common or be paid its preference, but not both. It is important to understand the subtle differences of preferred stock.

Step 3—Setting the Strike Prices for the Different Classes of Equity

In general, classes of invested capital convert in a sequential manner. Conversion starts with the invested capital with the lowest price per common stock equivalent ("CSE"). Subsequent conversion of other invested capital will follow this pattern. ❖

EXECUTIVE SUMMARY

■ It is essential for board members, executive officers, CFOs, auditors and private equity investors to comprehend option-pricing models used to determine the per-share values of common and preferred shares.

■ The AICPA Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, de-

scribes three methods of allocating value between preferred and common equity, which include:

- Current Value Method ("CVM")
- Probability Weighted Expected Return Method ("PWERM")
- Option-Pricing Method ("OPM")

■ OPM, which is based on the Black-Scholes model, is a common method for allocating

equity value between common and preferred shares.

- Valuation models must be tailored to the specific facts and circumstances of the equity in the company being valued.

Andrew C. Smith, CPA/ABV, ASA, CVA, CMA, is a partner and the managing director of valuation services at The McLean Group.

Jason C. Laurent, AVA, is an analyst at The McLean Group. Their e-mails are asmith@mcleanllc.com and jlaurent@mcleanllc.com, respectively. The McLean Group is a middle market investment bank that performs business valuations for public and private companies. The McLean Group's Web site is www.mcleanllc.com.

Step 4—Allocating Value

Value is then allocated to each equity class based on each class's ownership at different equity levels, as determined by call options.

COMPREHENSIVE EXAMPLE

Step 1—Determine Business Value & Black-Scholes Assumptions

For this example, we will look at a hypothetical company ("XYZ" or "the Company") and assume an enterprise value of \$50 million. We have arbitrarily chosen the time to liquidity (two years), volatility (50%), and the risk-free rate (5%). Defining and properly supporting these assumptions are paramount to a proper allocation of value.

Standard interest-bearing debt that calls for periodic interest and principal payments is typically valued at its face amount

(which is reasonable if the interest rates reflect market rates). In our example, we have assumed a net debt obligation of \$1 million. Consequently, the debt's amount, net of any excess cash, is subtracted from the company's enterprise value to determine the underlying value used in the OPM. XYZ's enterprise value of \$50 million less its net debt of \$1 million results in an underlying value attributable to remaining invested capital of \$49 million.

Step 2—Understanding the Capital Structure

The hypothetical preferred rounds were structured so that Preferred A benefits from its liquidation preference and its conversion to common. In contrast, Preferred B is entitled to *either* its liquidation pref-

erence or its conversion to common. The Company's capital structure in terms of CSEs is summarized in Exhibit 1.

Step 3—Setting the Strike Prices for the Different Classes of Equity

Under the OPM, the point at which each class of equity becomes "in-the-money" is viewed as a call option. It is therefore necessary to determine the underlying value where each class would receive value, known as the strike price.

Value for Payoff to Common Shareholders

Conceptually, payoff begins to accrue to common equity when all other contractual obligations have been fulfilled. In our example, XYZ's common shareholders will start receiving some proceeds when the Company's

Exhibit 1 Capital Structure

	Face Value Preference	Shares Outstanding	Common Stock Equivalents (CSE)	Percentage of CSE
Standard Interest-Bearing Debt, Net of Cash	\$1,000,000	-	-	-
Convertible Debt	\$1,000,000	-	100,000	11.1%
Preferred A (10% Dividend Yield)	\$5,000,000	100,000	100,000	11.1%
Preferred B (15% Dividend Yield)	\$5,000,000	100,000	100,000	11.1%
Common	-	500,000	500,000	55.6%
Options (\$0.20 Strike Price)	-	100,000	100,000	11.1%
Total		800,000	900,000	100.0%

Exhibit 2 Strike Prices for Participation

	Common	Preferred A	Options	Convertible Debt	Preferred B
Convertible Debt	\$1,000,000	\$1,000,000	\$1,000,000	NA	NA
Face Value of Preferred A, Plus Accrued Dividends	6,000,000	6,000,000	6,000,000	6,000,000	6,000,000
Face Value of Preferred B, Plus Accrued Dividends	6,500,000	6,500,000	6,500,000	6,500,000	NA
Claims to Be Paid Prior to Equity Participation	\$13,500,000	\$13,500,000	\$13,500,000	\$12,500,000	\$6,000,000
Preference at Liquidity	NA	6,000,000	NA	\$1,000,000	\$6,500,000
Number of CSEs	500,000	100,000	100,000	100,000	100,000
Strike Price Per CSE	NA	NA	0.20	10.00	65.00
Outstanding CSEs When Equity Class Participates	500,000	600,000	700,000	800,000	900,000
Necessary Additional Equity	-	-	140,000	8,000,000	58,500,000
Less Cash Proceeds From Options	-	-	(20,000)	(20,000)	(20,000)
Necessary Additional Equity, Net	-	-	\$120,000	\$7,980,000	\$58,480,000
Strike Price for Participation	\$13,500,000	\$13,500,000	\$13,620,000	\$20,480,000	\$64,480,000

debt and amounts owed to preferred shareholders have been paid. We used the preferred shares' liquidation value as of the time to liquidity, which includes any accrued and accumulated dividends. Doing so allows for the preferred shares' respective dividend rate to affect the value attributed to each equity class. Consequently, common shareholders will be able to receive value after the preferred stockholders and convertible debt holders have received their preferences.

For XYZ, the underlying value for payoff to the common shareholders is \$13.5 million, which is the total after \$1 million of convertible debt, \$6 million of Preferred A (face value plus two years of accumulating dividends), and \$6.5 million of Preferred B (face value plus two years of accumulating dividends). Accordingly, common equity will be modeled with a call option with a \$13.5 million strike price.

Analyzing the Participation of Each Equity Class

After common stock and fully participating securities, the additional classes of invested capital will convert based on their respective price per common stock equivalent, with the lowest converting first. Exhibit 2 summarizes the strike price

or equity value when each class of equity will participate.

Preferred A

Preferred A is participating as it benefits from both its liquidation preference and also its automatic conversion to common after its liquidation preference has been realized. Preferred A's value is derived from a combination of call options. First, its liquidation preference is modeled with a call option with a strike price of \$1 million on the underlying value since Preferred A is paid after the convertible debt. Then, the value of its automatic conversion feature is estimated using a call option that has a strike price of \$13.5 million, or the underlying value necessary for payoff to begin to common shareholders. Lastly, the dilution from the subsequent conversion of the remaining invested capital will be taken into account as detailed in our final allocation of value.

Options

Options differ from other types of invested capital in that these securities carry a strike price. Consequently, the exercise of options will not only dilute a company's equity, but also provide cash proceeds. As with other forms of invested capital that

carry an option to buy a company's equity, the necessary enterprise value for exercise must first be assessed. It is assumed that vested and non-vested options as of the valuation date will be exercised upon a liquidity event. All granted options should typically be included in the model.

In the example, there are 100,000 vested and non-vested options at a strike price of \$0.20. The payoff to common shareholders starts at \$13.5 million, with both converted Preferred A and common shares outstanding, for a total of 600,000 CSEs outstanding. However, at \$13.5 million, the common stock equivalents have a \$0 per-share price. Options will be exercised only if the 700,000 outstanding shares (CSEs and options) have a per-share price of at least \$0.20, the options' exercise price. Accordingly, the underlying value must be \$140,000 over the \$13.5 million floor for the 700,000 common stock equivalents to have a per-share price of \$0.20.

Also, the cash proceeds from the exercise of options must be taken into account. At an underlying value of \$13,640,000, 100,000 options will be exercised providing \$20,000 in cash proceeds. Accordingly, the floor level of \$13,640,000 for the exercise of options should be reduced by \$20,000 to \$13,620,000.

Exhibit 3 Option-Pricing Model Assumptions

Equity Value Summary

Estimated Enterprise Value	\$ 50,000,000
Less Standard Interest-Bearing Debt, Net of Cash	\$ (1,000,000)
Underlying Value Attributable to Remaining Invested Capital	\$ 49,000,000

Summary of Equity

	Preference at Liquidity	Underlying Value for Payoff	Underlying Value for Conversion/Exercise	Shares Outstanding	Common Stock Equivalents (CSE)	Percentage of CSE
Convertible Debt	\$1,000,000	\$0	\$20,500,000	-	100,000	11.1%
Preferred A (10% Dividend Yield)	\$6,000,000	\$1,000,000	\$13,500,000	100,000	100,000	11.1%
Preferred B (15% Dividend Yield)	\$6,500,000	\$7,000,000	\$64,500,000	100,000	100,000	11.1%
Common	-	13,500,000	-	500,000	500,000	55.6%
Options (\$0.20 Strike Price)	-	-	\$13,620,000	100,000	100,000	11.1%
Total				800,000	900,000	100.0%

Option-Pricing Assumptions

Risk-Free Rate	5.00%
Volatility, 2-Year Average	50.00%
Time to Liquidity Event (Years)	2.0

Convertible Debt

In the example, XYZ has a \$1 million debt liability that can convert to 100,000 common shares, while 700,000 CSEs are currently outstanding (common, Preferred A, and options). For the debt to convert, the per-share price of the Company's CSEs must be at least \$10 so that the value of the converted shares equals \$1 million. At \$10 per share and 800,000 outstanding shares (700,000 CSEs and 100,000 from the debt's conversion), the underlying value must be \$20,480,000 [the \$13.5 million starting point for payoff to common, plus an additional \$8 million (or \$10 per share with 800,000 CSEs outstand-

ing), less the \$20,000 of cash proceeds from the options, less the forgiven \$1 million debt]. It should be highlighted that if the debt converts, the Company is no longer responsible for the original \$1 million liability.

Preferred B

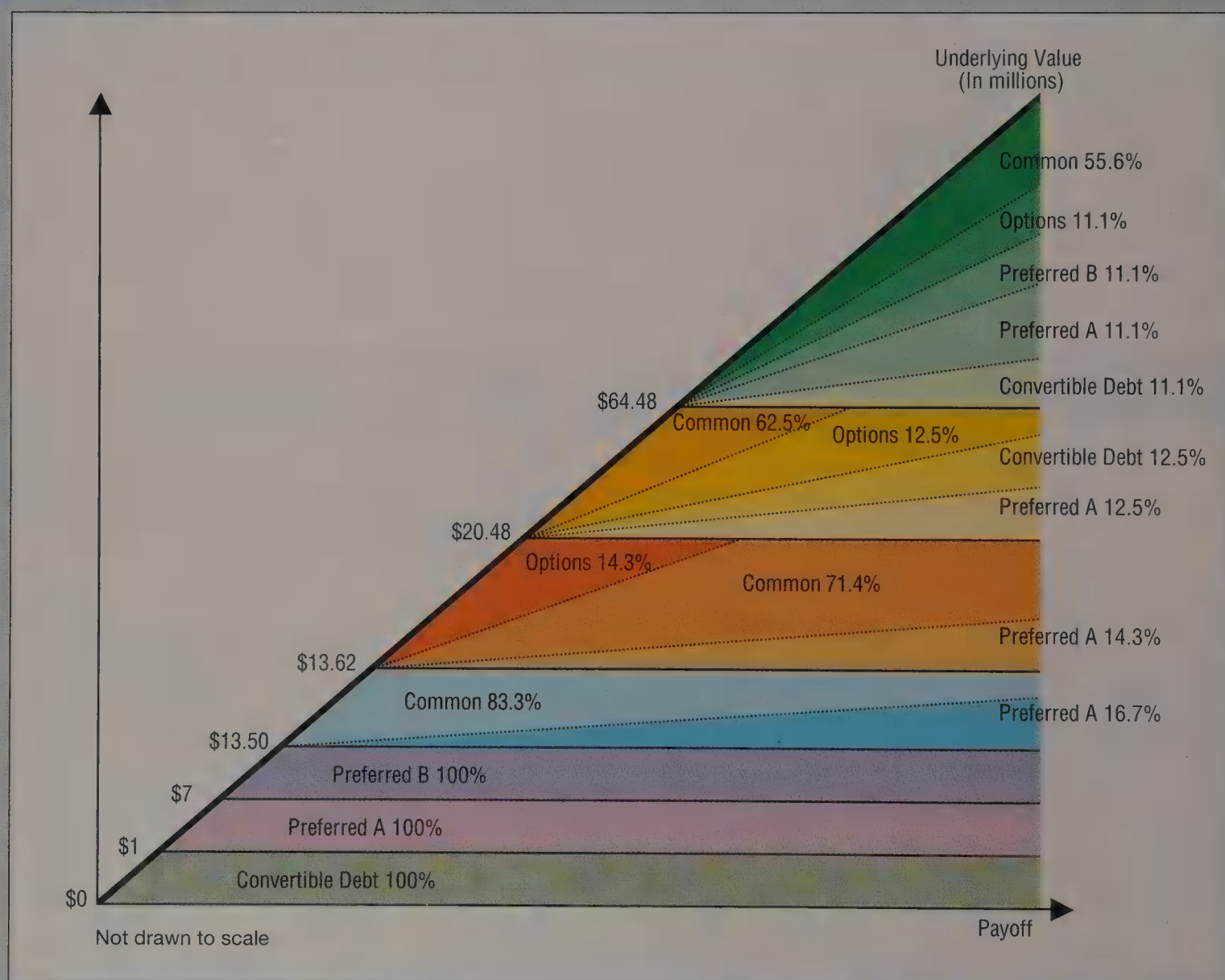
Preferred B is modeled in a similar way to the convertible debt. As it can only benefit from its liquidation preference or its conversion to common, we need to calculate the value at which the Preferred B would convert. For Preferred B to participate in the equity of the Company for a value greater than its preference, the un-

derlying value must be \$64,480,000 [the \$13.5 million starting point for payoff to common, plus an additional \$58.5 million (or \$65 per share with 900,000 CSEs outstanding), less the \$20,000 of cash proceeds from the options, less the forgiven \$1 million of convertible debt, and less the forgiven Preferred B preference]. Similar to the convertible debt, if Preferred B converts, it will not benefit from its preference.

Step 4—Allocating Value

The next step is to allocate XYZ's enterprise value between its different classes of equity. First, Exhibit 3 summarizes the key assumptions to the model.

Exhibit 4 Allocation of Incremental Proceeds





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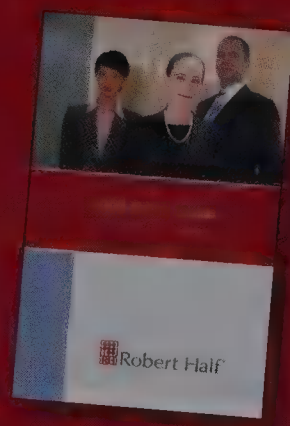
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XYZ's equity structure is illustrated in Exhibit 4. In this example, all proceeds up to \$1 million would go to convertible debt. The next \$6 million (the tranche from \$1 million to \$7 million) would be paid to Preferred A. Similarly, the next \$6.5 million would be received by Preferred B. Then the next \$120,000 (the tranche from \$13.5 million to \$13.62 million) would be split between Preferred A, receiving 17%, and common shareholders, who would receive 83%.

Once we understand the capital structure and the behavior of the equity classes at different levels of value, we then derive the value of the respective call options by using the Black-Scholes model. The value of each equity tranche represents the difference between each call option price (or the incremental change in value for each option). Exhibit 5 summarizes the value for each option based on the strike price for each equity class.

Next, we allocate the value of each equity tranche to the equity classes that participate in it, based on their respective percentage of ownership, as summarized in Exhibit 6 (note, totals may not recompute due to rounding).

Based on the information presented above, we are able to model each class of invested capital as a combination of call options. The total value for the various classes of equity must total the \$49 million value of the respective invested capital.

CONCLUSION

Like many issues in business valuation today, best practices are evolving and there are disparities among professionals. Many issues in valuation are still unresolved and subject to debate (such as reflecting voting and non-voting rights, applicability of discounts for lack of marketability, etc.), and the applications and underlying details of the option-

pricing method are no exceptions. Valuation models must be tailored to the specific facts and circumstances of the company and the securities being valued. ♦

AICPA RESOURCES

JofA articles

- "A Bid for Fair Value," Sept. 07, page 42
- "Frontline Reaction to FASB 123(R)," April 07, page 54
- "No Longer an 'Option,'" April 05, page 63

Conferences

- AICPA/ASA National Business Valuation Conference 2008, Nov. 10–12, Las Vegas
- AICPA National Business Valuation School, Aug. 18–22, Lewisville (Dallas), Texas

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Exhibit 5 Call Options—Black-Scholes Model

Inputs	Call Option 1	Call Option 2	Call Option 3	Call Option 4	Call Option 5	Call Option 6	Call Option 7
Underlying Value	\$49,000,000	\$49,000,000	\$49,000,000	\$49,000,000	\$49,000,000	\$49,000,000	\$49,000,000
Volatility	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%
Risk-Free Rate	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Strike Price	\$0	\$1,000,000	\$7,000,000	\$13,500,000	\$13,620,000	\$20,480,000	\$64,480,000
Time to Liquidity	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Call Option Price	\$49,000,000	\$48,095,163	\$42,672,681	\$36,938,445	\$36,835,758	\$31,258,565	\$10,588,745
Tranche Value	\$904,837	\$5,422,482	\$5,734,236	\$102,687	\$5,577,194	\$20,669,819	\$10,588,745

Exhibit 6 Allocating Equity Value

Threshold Underlying Value	Call Option Tranche	Tranche Value	Applicable Classes	Applicable Shares	Convertible Debt	Preferred A	Preferred B	Common	Options	Total
\$0 to \$1,000,000	1-2	\$904,837	Convertible Debt (CD)	-	100.0%	-	-	-	-	100.0%
\$1,000,000 to \$7,000,000	2-3	\$5,422,482	Preferred A (A)	100,000	-	100.0%	-	-	-	100.0%
\$7,000,000 to \$13,500,000	3-4	\$5,734,236	Preferred B (B)	100,000	-	-	100.0%	-	-	100.0%
\$13,500,000 to \$13,620,000	4-5	\$102,687	Common (C), A	600,000	-	16.7%	-	83.3%	-	100.0%
\$13,620,000 to \$20,500,000	5-6	\$5,577,194	C, A, Options (O)	700,000	-	14.3%	-	71.4%	14.3%	100.0%
\$20,500,000 to \$64,500,000	6-7	\$20,669,819	C, A, O, CD	800,000	12.5%	12.5%	-	62.5%	12.5%	100.0%
\$64,500,000 to <	7	\$10,588,745	C, A, O, CD, B	900,000	11.1%	11.1%	11.1%	55.6%	11.1%	100.0%
\$49,000,000				Value	\$4,665,092	\$9,996,593	\$6,910,763	\$22,870,555	\$4,556,997	\$49,000,000
				Shares	-	100,000	100,000	500,000	100,000	800,000
				Per Share	-	\$99.97	\$69.11	\$45.74	\$45.57	

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Take Your New Team to the Top

How to motivate the
accounting and finance team to
add value to your organization

by Pam J. Callenwater

The challenge for any leader moving into a new organization is to hit the ground running, quickly bringing value to the business he or she is supporting. In no field is this more true than corporate finance, where pressure to reduce costs is high and management tenure increasingly short.

Mike Kaelin, vice president of finance for a business unit of RTI International, has a track record of building high-performing finance teams who are recognized for bringing value to the businesses they support. He has refined a process for evaluating, motivating and building teams over the course of his last three financial leadership positions and shares the system and lessons learned along the way.

A Five-Step Process:

1. Start with a clear vision for the finance team.
2. Interview key stakeholders.
3. Evaluate the current organization.
4. Identify a "right hand."
5. Continue the process of assimilation.

THE VISION

Start with a clear vision of a finance team that is involved in the business and engaged in key management decisions. This vision is communicated to both the team and the key stakeholders outside of the finance team. Your vision will be used to develop, implement and measure the success of specific objectives and tactics during the execution of the rest of this process.

This step is vital. Everyone wants to know where they are going and why.

THE STAKEHOLDERS

Identify and engage key stakeholders right away. This step includes both your boss and peers outside the walls of finance. These internal clients or customers should be treated the same way you would

treat clients if you were running a private practice. Your mission is to serve and complement their needs.

Conduct structured interviews to identify what is most important to your internal customers. If your predecessor did not share your value-added approach, then initially your peers may not understand the reason for your questions, says Kaelin.

At this point you are building your relationship in the organization and looking for opportunities to demonstrate how your team can bring value to internal customers. In effect, you are teaching your team how to serve while teaching the business how to be served by your team.

Meeting with internal customers is not a one-time event; it is an ongoing process. Kaelin schedules one-on-one meetings with each customer every two weeks. While this requires a significant amount of time, it helps tremendously when it comes to implementation. Transitions are much smoother as the customers discover that their input results in specific actions.

THE CURRENT ORGANIZATION

A quick evaluation of the existing organization is critical to a new leader's success. In addition to ending the suspense for team members, it is essential to know the strengths of existing team members and to determine that everyone is in the right role to leverage their strengths and interests.

In individual interviews with your group, give each team member an opportunity to start learning about you while you

Questions for Stakeholders

- Describe your organization.
- What are your strategic business challenges?
- What are the company's business challenges?
- What process, if improved, can increase the productivity of your staff?
- What are your perceptions of your current finance team?
- What do you want/need from the team?
- Where can I be an asset to you?
- What are the top 3 things I should focus on?
- Whom on your team should I talk to for additional perspective?

learn about them. Start by asking team members to describe their current roles and to explain their work history in the organization. Also ask about their past positions and probe to discover what their biggest challenges are. Make a point to learn what does and does not motivate them and how you can help them be more successful.

THE RIGHT HAND

During the initial assessment period, look for someone who can be your "right hand." This is someone who shares your vision for the finance team. Kaelin sometimes finds this person on an existing team and at

other times goes outside of the organization to find this critical person. In this individual you are looking for someone whose skills complement yours.

Another factor is making certain that this person is right for your current organization. At times it is tempting to hire someone who has worked for you in a previous company. Sometimes this can be a great move, but just because an individual was well-suited for a prior situation does not mean that they are the right fit for the next one.

A final consideration is cultural fit. If changing the culture of the existing team is a goal, then it is essential for this "right hand" to be an effective cheerleader for the changes that are slated to take place in the organization.

ASSIMILATION

The heavy lifting comes next. Now that you have input from the internal clients your department supports and have developed some initial impressions of the members of the team you inherited, the next step is to learn more about your team and help them learn more about you. This is a critical step as it builds the next level of trust required to work toward changing the organization.

Kaelin calls on the human resource department for assistance with the first step in the assimilation process—a team meeting facilitated by HR. This meeting is held off-site in an informal setting. The team is given 13 questions to answer about Kaelin. ♦

EXECUTIVE SUMMARY

■ **Vision.** Start with a clear vision of a finance team that is involved in the business and engaged in key management decisions.

■ **Stakeholders.** Identify and engage key stakeholders right away. Conduct structured interviews to identify what is most important to your internal clients.

■ **Current Organization.** Immediately evaluate the existing organization by asking team members to describe their current roles and to explain their

work history in the current organization.

■ **Right Hand.** During the initial assessment period, also look for someone who can be your "right hand." This is someone who shares your vision for the finance team.

■ **Assimilation.** Hold a team meeting facilitated by HR. Reward team members who clearly fit the new vision. Strategically recruit new employees who will mix well with the team and

encourage them to move in the new direction.

■ **Lessons.** Timing is critical; don't delay tough decisions. Create the right blend of new team members with established staff to maximize results. Respond quickly and effectively to the small things first to achieve "early wins" and build confidence.

■ **Don't take on too much at once.** Don't settle for less than what you want to achieve. Communicate important issues up the

organization. Have the tough conversations.

Patti J. Gillenwater is the CEO of Raleigh, N.C.-based Elinvar, an executive search firm that specializes in recruiting and retaining top talent for finance organizations. Her e-mail address is patti@elinvar.com. Mike Kaelin is a former candidate and current client of Elinvar.

He does not attend this part of the meeting. After they have answered these questions, Kaelin comes into the meeting and reviews their answers and addresses the additional questions raised during the ses-

dynamics and note the level of engagement of the team members. During this process, the team develops a list of what needs to be done. Having the "to-do list" come from the team creates a dynamic

Early in the process, find ways to reward team members who clearly fit the new vision.

sion. This process provides a very "safe" environment for the team members to learn what they want to know about their new leader.

More information about the team is also revealed during this session. You have an opportunity to observe the team

that fosters the support of the team members from the beginning of the change initiative.

The final and probably most important benefit of this exercise is that it opens the door for communication between you and the individuals on your team. This environment gives you a chance to let the team see your human side. By being open and willing to share about yourself, you encourage a level of trust that facilitates the relationship building needed to effect change.

Your goal is to create an environment where your staff will bring the issues to you. Early in the process, find ways to reward team members who clearly fit the new vision. As you determine who will not contribute well to the new organization, strategically recruit new employees who will mix well with the team, and encourage them to move in the new direction that you have set.

LESSONS LEARNED

Kaelin is the first to admit that he has made mistakes along the way. Here are some tips based on these experiences:

- The timing of when you make changes is critical. Be careful not to delay making the tough decisions.
- Create the right blend of new team members with the established staff and refocus to get maximum results.
- Respond quickly and effectively to the small things first. This creates early wins, which build confidence within the team and within the organization you are serving.
- Take on the big challenges after building your credibility within the organization.
- Do not take on too much at once.

Traits of High-Performing Finance Teams

- Hard working, motivated and ambitious
- Good sense of urgency
- High energy
- Willing to reach out into the organization and solve problems

- Be resolute in your goals—do not settle for less than what you want to achieve.
- Communicate important issues up the organization.
- Have the tough conversations.

To be successful in today's climate, financial leaders are required to have more than technical accounting skills. The ability to attract and retain top financial talent and meld and motivate these talented individuals into a high-performing team is essential.

This process is a great example of how a strong technician can expand his or her abilities and achieve more through effective deployment of a talented group of finance professionals. Making this effort a priority is certain to enhance the success of your career and the success of the business you are supporting. ♦

Assimilation Session Questions

- What do we already know about _____?
- What would we like to know about _____ that we do not know?
- What does _____ need to know about us as a group?
- What are our concerns about _____ becoming our leader?
- What information or actions do we want from _____?
- What can _____ do to make us the most productive we can be?
- What can we do to make our team more effective?
- What can we do to make _____ more effective?
- What is our team known for?
- What should our vision and mission statements be?
- What are the major challenges _____ will face during his first year?
- What major challenges will _____ and our team face during the first year?
- What recommendations do we have for meeting those challenges?

AICPA RESOURCES

JofA articles

- "A Strategic Player," July 06, page 51
- "Jump-Start Success," Feb. 05, page 34

CPE

- *Lean Accounting and Management: Improving Profitability by Streamlining Operations*, a CPE self-study course (#731274)
- *The Controller Today: Innovative Management Tips and Techniques*, a CPE self-study course (#731983)
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CORNER OFFICE CONVERSATIONS

Building Value in People

Barry Salzberg took the reins of Deloitte & Touche USA LLP as CEO in June 2007, three decades after the firm hired him as a tax specialist. As the U.S. managing partner from 2003–2007, he helped then-CEO James Quigley shape Deloitte's strategy and was credited with advancing recruitment and diversity initiatives at the firm, which employs 40,000 people.

He spoke recently with the *JofA* about the path to partnership, leveraging the skills of the younger generation and how he learned the hard way about the value of transparency.

JofA: What was your worst career move, and how did you recover from it?

Salzberg: I don't know if it's a career move, but an interesting experience, if you will, maybe a mistake—I once, on a very important engagement as a young partner, failed to share something critical with the senior advisory partner on that client. And I remember it distinctly because that partner was in a meeting with the client and was caught off guard because he didn't know of what had occurred.

Interestingly, what had occurred was positive, meaning that I was given very positive feedback from the client for handling a very difficult and sensitive matter. However, I used poor judgment by not advising the senior partner, notwithstanding the fact that it was good stuff.

The senior partner was upset and called me on the carpet for not having the appropriate protocol and communication. I recovered from that. I learned that that's not the way to handle the internal hierarchical leadership of an account, but rather I needed to be more communicative, more transparent with good or bad information. I think that today my partners would say that transparency is a hallmark of my leadership. I don't like surprises.

JofA: What was your smartest career move?

Salzberg: As a partner, maybe as managing partner, some of my finer moments, I think, were handling the Arthur Andersen situation—hiring a number of people from Arthur Andersen—and,



Barry Salzberg

separately, the reintegration of Deloitte Consulting.

First there was the strategy of convincing our senior leadership that hiring some of [the Andersen] folks was the right thing for us to do and handling the cost that would be associated with it. There also was the difficulty of actually accomplishing it. We hired 2,000-plus people one by one through a resume and interview process. Once these people accepted our offer of employment, we actually brought them all on physically into our firm on the same day. So the Andersen situation was big for me.

As for Deloitte Consulting, it was separate from the rest of the firm, served a different client base and was culturally different as well. We needed to make some wholesale changes in order to comply with [the Sarbanes-Oxley Act]. This involved creating a financial discipline and redesigning the market space and strategy for consulting, and this was coming from a guy who had no prior background in that business, nor much association with consultants given the nature of the technical work that I did as a client-service partner. So it was a very tough integration.

Both those things happened within a year of each other, and I was in a very senior leadership role and had been tagged with successful execution against both of those events. Today, I think that they've contributed to the respect that people have for me and the confidence that people have in the decisions that I make.

JofA: Talk about your top priorities for this first year in your CEO role.

Salzberg: My priorities, as I outlined them for my partners, essentially fell into four categories. One is clients. One is people. The third is how to make it easier for us to conduct business, and the fourth is with respect to the marketplace for our firm.

And it's important to know that all four of these priorities are founded on ensuring a continued focus on quality and on innovation. With respect to clients, the goal is ensuring a level of client service that rises to a standard of excellence.

In terms of people, it's a talent agenda really focused on ensuring that our people's careers are enhanced, that we're creating the right kind of environment for them and adapting to the shifts in employee values and thinking.

Easier to do business would be in terms of our organizational structure and, as we're getting bigger and larger and more complex in the broader footprint, being able to better migrate our organization internally, and as we engage with clients externally to ensure that the processes—in terms of engagement letters, contractual relationships, alliances and the like—are more effective.

And then, of course, in terms of the marketplace, my focus is on ensuring that we are creating eminence, that we are building our revenue base and our market share and the like.

Editor's Note

This is the first installment of "Corner Office Conversations," an occasional series of personal talks with high-level leaders in accounting and finance.

JofA: *How will you measure success on those priorities?*

Salzberg: We have what we call a balanced scorecard. And in essence we measure a lot of the things that we do that support each of the four priorities I just mentioned. The metrics are communicated to our partnership, and quarterly we assess the performance of our firm in connection with 14 different measures of success that support our priorities.

You treasure what you measure, and in essence we decided to make sure that we are not just measuring it, but communicating it to our people so that we can hold ourselves accountable for it. The measures include tenure of our people. And we measure the retention rate for our highest performers, for example. The measures also include things such as continuous improvement in employee engagement, market share and revenue growth, to name a few.

JofA: *What are some of the challenges of working with the younger generation of CPAs?*

Salzberg: I think the biggest challenge is that every generation is different than the one preceding it. And I think that this particular generation has a more demonstrable set of different priorities, different expectations than the generation that preceded it.

They are uniquely focused on a completely different opinion of how, when, why work has to be done than prior generations. They tend to be super-achievers and demand a much greater work/life balance. They demand a much greater role in interesting and challenging work. They kind of want leadership responsibility from the get-go. And they're a technologically savvy bunch. They're a multitasking bunch. They're a very open and communicative bunch.

And so the biggest challenge is coexisting for generations of people and creating an environment that adapts to each but doesn't dilute the singular culture and commitment to a standard of excellence.

I think that we are dealing with those challenges right now. It's about adapting to a generation's needs and wants. If you don't adapt to it, they'll adapt by walking away and finding a job elsewhere. When such a supply and demand gap exists, it is critical to address generational issues, learn to take advantage of differences, and work together to achieve success.

JofA: *What advice would you give a young CPA on successfully traveling the road to partner?*

Salzberg: A couple of tidbits. One is stay on the right of right. Make sure that you're always thinking about what's right and never losing sight of that in terms of your morals, your ethics and your work performance.

Two, I would advise a young CPA to "work hard, be strong." I would say that both of my sons learned this as they were going through their black belts in tae kwon do. "Work hard, be strong" is the phrase that was their motto. I would tell young folks today to work hard and make sure that you're putting in the best that you can to every project, every situation, no matter how tedious or challenging it is. And really learn from every

experience so that you can leverage your foundational strengths.

Beyond these two main pointers, I would tell young people to broaden their interests, never put their eggs in one basket too early. Learn about the world, become educated outside of the area of competence that they're working in—business skills and the like.

I would tell young folks that they need to broaden their strengths—not just technical, but people-related skills—learn how to network and socialize, learn public speaking and interaction-type skills, whether that's negotiating skills, sales skills or problem-solving.

And finally I would say that—I have mixed feelings about this, but I believe it—while it's very important to be generalists in terms of your core competencies, I think it's also extremely important to be a specialist. I don't know how broad a specialty can be, but sometimes being a generalist is a specialty. I think that having that core thing that you're famous for—whether it's a product, a competency, or a particular belief, I think is important.

JofA: *You've spent years in a segment of the profession known for high pressure and long hours. Has it all been worth it?*

Salzberg: I'm going to have to answer that question unequivocally yes, because of where I am right now. I love what I do. I love the firm that I'm with. I feel respected. I feel that our people—at all levels through partner—appreciate the leadership that I'm providing.

While you're working crazy hours and under lots of stress, both of which are still true for me today, you always question whether or not it's worth it at times, no doubt about that. But now, in hindsight, I've got a wonderful family. I haven't in any way impacted that negatively and I, myself, am sort of at a peak in my career. So when I put both of those together, that hard work has to have been worth it.

JofA: *What would have been your second choice of careers?*

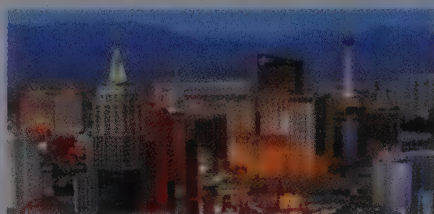
Salzberg: I taught for four or five years. I grew up in Deloitte, teaching many courses here in Deloitte, but also teaching at the master's level at a university here.

I love the exchange with students and the fresh thinking. I love the challenge of having to be on top of your game in every one of those interactions with students and [having to] make sure that you're educating them and helping them understand something that you obviously personally love and know. And seeing the growth in the students from the day before they take my course to the day after.

So that's a huge passion of mine, and I think education, learning and development is something that I'm going to devote a lot of my energy to here at Deloitte for the balance of my term.

And when I subsequently retire, whenever that might be, that will be the career I assume again, in whole or in part, and go back and teach at the university level. ♦

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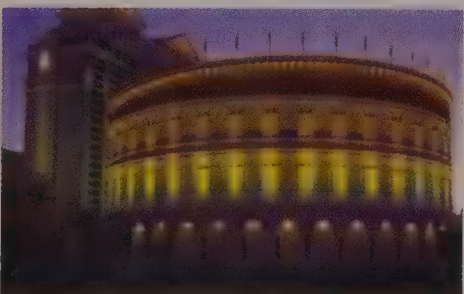


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- Keynote presentations by: Robert Herz and Mark Weinberger
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AICPA National Conference on Employee Benefit Plans



Bellagio
Las Vegas, NV
May 13-15, 2008

Pre-Conference Workshops:

Monday, May 12, 2008

CPE Credits: 21.5 (main conference),
up to 12 (optionals)

Conference Highlights:

- Addresses both the tax and audit side of employee benefit
- Up-to-date regulatory information
- Practical guidance and tools
- Latest on the Employee Benefit Audit Quality Center

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Scottsdale Marriott at
McDowell Mountain
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June 3-4, 2008

Pre-Conference Dinner Session:

Monday, June 2nd

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Conference Highlights:

- Challenge emerging partners, encourage new responsibilities
- Enhance skills as future firm leaders
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Additional Conferences

Tech+: AICPA Information Technology Conference

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Las Vegas, NV
June 9-11, 2008
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Pre-Conference Workshops: June 18, 2008

AICPA Small Business Practitioners Tax Conference

The Venetian
Las Vegas, NV
July 14-15, 2008
Pre-Conference Workshops: July 13, 2008



TAX PRACTICE CORNER

A 401(k) Tax Break That's Often No Break

Withdrawing company stock from a 401(k) to take advantage of a tax break called net unrealized appreciation (NUA) sounds like a no-lose proposition, and most advisers tell their eligible clients to go for it. But there's just one big problem: When you run the numbers, this maneuver often doesn't pay off.

Many employees accumulate substantial company stock in their 401(k), especially if they have worked for the company many years and the stock has done well. (And the individual may be overconcentrated in it.)

When the employee retires, leaves the company or otherwise qualifies for a lump-sum distribution, he or she may remove the stock from the plan and put it in a taxable account but still get favorable tax treatment. Only the cost basis of the stock counts as ordinary taxable income. When the stock is sold, the additional "unrealized" appreciation that occurred within the 401(k) is taxed at long-term capital gains rates. So if the stock's basis is \$20,000 and it's now worth \$100,000, the transfer and an immediate sale will produce \$20,000 in ordinary income and \$80,000 of long-term capital gain. Most people who take advantage of NUA sell the stock immediately, but this isn't required. Any sale *after* the transfer out of the 401(k) will produce a separate long- or short-term gain or loss.

However, be aware that a 10% withdrawal penalty for early distribution could apply if the employee is under age 59½, unless he or she is at least 55 and there is a complete separation from service. To determine full eligibility and make sure other requirements are met, see IRS Publication 575.

In contrast, if the stock is rolled over into a traditional IRA, the entire amount will be counted as ordinary income as it's withdrawn during retirement. Potentially, the tax savings under the NUA approach can be substantial. So what's not to love? Plenty.

Before advising your client to take the NUA option, run the numbers. On a spreadsheet, simulate the distribution, sale and federal and state tax returns, including the resulting additional

capital gains and ordinary income. Now, assume a realistic after-tax rate of return over time on the remaining asset.

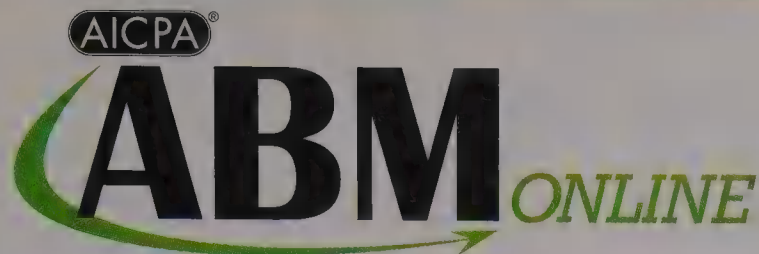
Next, compare that scenario with rolling over the stock into an IRA, selling it tax-free inside the IRA, assuming a suitably higher pre-tax rate of return, and paying taxes on the mandatory distributions starting at age 70½.

You'll probably discover that the NUA approach works best only when the cost basis is very low or the investment horizon is relatively short. Otherwise, as shown in the chart below and an interactive spreadsheet at www.aicpa.org/pubs/jofa/mar2008/download/taxpractice.xls, the client will have more money in the long term by transferring the stock to an IRA. With NUA, the funds grow at after-tax investment rates. In contrast, keeping the money in the IRA lets the entire amount grow until distributions start. And, while those distributions are fully taxable, the interim tax-deferred buildup—at higher, pre-tax, investment rates—can be substantial.

Market Value	\$100,000
Cost Basis	\$20,000
Investment Horizon (Years)	20
Marginal Tax Rates	
Ordinary Income	35 %
Long-Term Capital Gains	15 %
Annual Investment Return	
Pre-tax	9.00 %
After-tax	7.50 %
NUA (and Sale)	
Initial Value	\$100,000
Tax on Basis	(\$7,000)
Tax on Gain	(\$12,000)
Net Initial Value	\$81,000
Net Ending Value	\$344,076
IRA Rollover (and Sale)	
Initial Value	\$100,000
Ending Value	\$560,441
Tax on Withdrawal	(\$196,154)
Net Ending Value	\$364,287

Of course, there are situations in which the NUA option may be more profitable. If the client needs the money in the short term, taking advantage of NUA can make perfect sense. For many people, though, net unrealized appreciation is a net loser.

By **Robert J. DiQuollo**, CPA/PFS, CFP, a senior financial adviser with Brinton Eaton Wealth Advisors, in Morristown, N.J. He can be reached at diquollo@brintoneaton.com.



New!

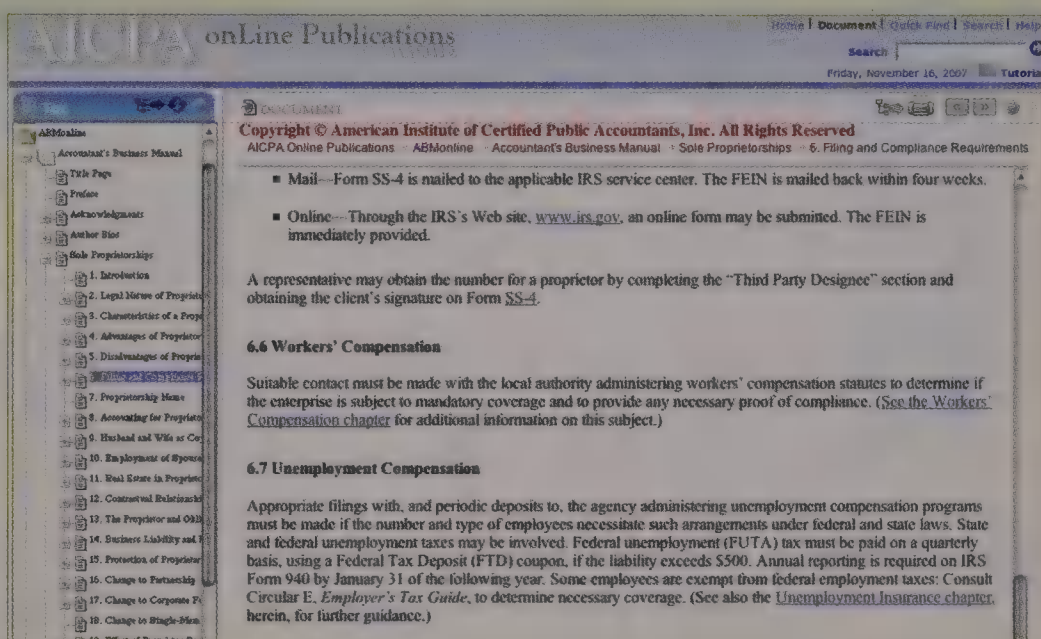
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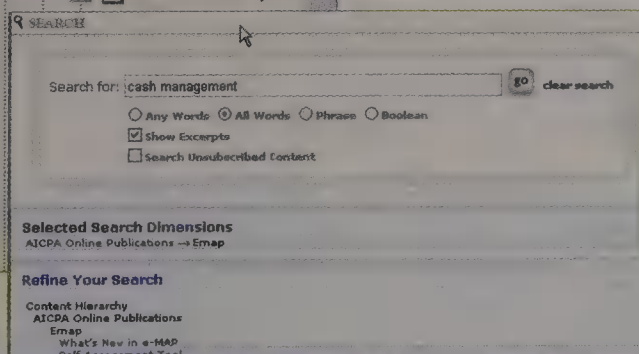
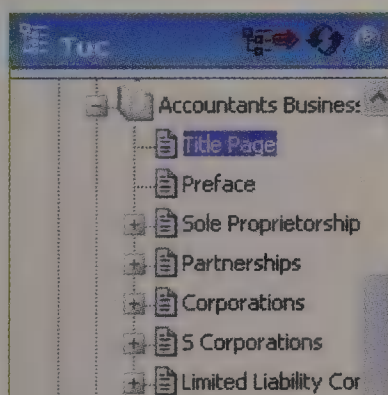
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TAX MATTERS

INCOME AND DEDUCTIONS

ENVIRONMENTAL CLEANUP, PRICE-FIXING SETTLEMENT NOT CLAIMS OF RIGHT

Two recent appellate cases further circumscribed the ability of taxpayers to claim a section 1341 deduction for income subject to a “claim of right.”

Section 1341 allows a deduction when a taxpayer had an apparent right to an amount over \$3,000 included in gross income in a prior year but subsequently discovers it did not have an unrestricted right to that income. Uncertainty surrounding such questions as what kinds of claims qualify and how intrinsically they must be related to the income against which they are deducted, however, often make applying this relief problematic.

From 1940 to 1987, aluminum manufacturer Alcoa Inc.’s production process created waste byproducts that required it to spend large sums in 1993 for environmental cleanup. Under the annual accounting period rules, these expenditures would have been deductible in 1993. But since the corporate tax rate in 1993 was significantly lower than in 1940–1987, Alcoa used section 1341 to deduct the costs from its income in the prior period. The government’s rejection of Alcoa’s resulting refund claim of more than \$12 million was upheld in 2005 by the U.S. District Court for Western Pennsylvania. The court based its ruling on a nearly identical case decided a short time earlier that year by the U.S. District Court for Eastern Virginia against Reynolds Metal Co. (*Reynolds Metal Co. et al. v. U.S.*, 96 AFTR2d 2005-6003). Alcoa appealed the Pennsylvania case to the Third Circuit.

The Third Circuit said in a Nov. 28, 2007, opinion that Alcoa’s retrospective deduction for its cleanup costs failed because the costs lacked a substantial nexus of circumstances, terms and conditions with the earlier income. The cleanup obligations did not arise from the earlier failure to spend the money but from new circumstances, terms and conditions—

notably a 1980 legislative mandate. Moreover, it wasn’t clear who was exercising a competing claim to the money. Earlier cases, along with the plain meaning of “restoration” and “restitution” referred to in section 1341’s legislative history, require payment to a specific individual or business and not simply an expenditure that benefits many.

It was also unclear to the court what relation the 1993 costs bore to amounts Alcoa would have incurred for cleanup during the earlier period and how the costs might have been apportioned over those 47 years. Although a “significant question,” this point was relegated to a footnote; Alcoa’s construal of the statute’s key elements, “while artful, is not convincing,” the opinion said.

In a separate case, the Federal Circuit Court of Appeals rejected a claim by Pennzoil-Quaker State Co. (the successor to Quaker State Corp.) for a \$4.4 million deduction claimed under section 1341. The amount was paid in 1995 as a settlement in a price-fixing lawsuit. The Federal Circuit overturned the 2004 decision of the Court of Federal Claims (94 AFTR2d 2004-6545), which had allowed the deduction. (See “Tax Matters: Section 1341 Clarified,” *JofA*, March 05, page 86.)

Quaker State claimed the payments as “other deductions” on its 1995 and 1996 tax returns, contending the settlement resulted in an overstatement of gross income of \$4.4 million for the years 1981–1995. Similarly to the Third Circuit in *Alcoa*, the Federal Circuit said Pennzoil-Quaker State’s “settlement payments did not arise from the same circumstances” as the oil company’s past understatement of cost of goods sold. The court also ruled the claim was barred by the “inventory” exception of section 1341(b)(2), which disallows the deduction when the item was included in gross income because of the sale of inventory.

These decisions, if followed by other courts, reject the use of section 1341 for claims lacking a clear and contemporaneous connection to income or an identifiable claimant.

■ *Alcoa Inc. v. U.S.*, 100 AFTR2d 2007-6815

■ *Pennzoil-Quaker State Co. v. U.S.*, 101 AFTR2d 2008-415

Prepared by **Edward J. Schnee**, CPA, Ph.D., Hugh Culverhouse Professor of Accounting and director, MTA Program, Culverhouse School of Accountancy, University of Alabama, Tuscaloosa.

INCOME AND DEDUCTIONS

A HARD NIGHT AT THE CASINO

In a summary opinion, the Tax Court ruled that a woman who operated a trucking business by day and played casino slot machines by night was a professional gambler, allowing her to deduct \$1.4 million in gambling losses as a business expense rather than as a miscellaneous itemized deduction. A key factor the court found in her favor was that although she usually gambled into the early morning hours and sometimes all night, she took no pleasure in it.

The IRS assessed the woman, Linda Myers of South St. Paul, Minn., a \$5,266 deficiency and \$1,055 penalty on her 2003 return. She argued that she had developed strategies for playing the slot machines that she believed would maximize her odds of winning. Although she didn’t report an overall profit from gambling in the three years preceding 2003 or the year after, she had won several large jackpots, including \$50,000 twice and ones exceeding \$1,200 more than 300 times in 2003. She had begun gambling in 1992 and by 2000 considered herself a professional. Myers also owned and operated a trucking business at which she worked 25 to 35 hours a week. Starting around 2 p.m. most days, she would spend the next 12 hours or more at a local casino.

An activity may be considered a trade or business if it is conducted with continuity, regularity and with the primary purpose of earning a profit. The continuity and regularity of Myers’ gambling were not disputed, but her profit motive was. The court analyzed it by

Cities Added to IRS Small Business Resolution Program

The Service expanded the number of test areas for its Fast Track Settlement program, which aims to resolve disputes with small businesses and self-employed taxpayers within 60 days of the issue developing. In addition to **Chicago, Houston** and **St. Paul, Minn.**, the case resolution program will be offered through Sept. 5 in:

Central New Jersey • **Laguna Niguel, Calif.** • **Philadelphia** • **Riverside, Calif.** • **San Diego**



Source: IRS, www.irs.gov

the nine nonexclusive factors of Treas. Reg. § 1.183-2(b). One factor, the taxpayer's history of income or loss from the activity, was held to favor the government. Two more factors were neutral or didn't apply: Myers did have substantial income (\$64,000) from another source, her trucking business. In other situations, this could indicate a motive for claiming offsetting losses. But since IRC section 165(d) limits deductions for gambling losses to the extent of winnings, they would not avail her for this purpose. Likewise, an expectation that assets used in the activity may appreciate in value was held not to apply.

The remaining six factors were held to favor Myers:

1. **The manner in which the taxpayer carried on the activity.** She retained her bank and credit card statements and copies of casino records, including a player card account and IRS forms W-2G, *Certain Gambling Winnings*. Although she didn't maintain separate books on her gambling, she kept a daily tally of how much money she took to the casino.

2. **The expertise of the taxpayer or his or her advisers.** The continuity and regularity of her play, coupled with her study of the machines and other gamblers, indicated she had gained expertise.

3. **Success of the taxpayer in other**

activities. Myers had succeeded in the trucking business, the court said.

4. **Amount of any occasional profits.** The court noted her occasional large wins and frequent smaller ones.

5. **Time and effort expended by the taxpayer on the activity.** The court said her gambling regimen satisfied this factor, in light of the next one:

6. **Whether elements of personal pleasure or recreation were involved.** The court noted that casino gambling is commonly thought to be recreational. But it considered credible Myers' testimony that she found no pleasure in gambling and considered it not just work, but stressful, tiring and time-consuming toil.

Although this ruling may not be appealed by the IRS and may not be treated as precedent, it does provide one illustration of how an activity may be conducted as a trade or business for tax purposes. For a contrasting decision, see *Jose Calvao v. Commissioner*, TC Memo 2007-57.

■ *Linda M. Myers v. Commissioner*, TC Summary Opinion 2007-194

Prepared by **Tina Quinn**, CPA, Ph.D., chair and associate professor of accounting, Arkansas State University, Jonesboro, Ark.

GIFTS AND ESTATES

DUNN DOES IT AGAIN

The Eleventh Circuit Court of Appeals vacated a Tax Court judgment and allowed a valuation discount of 100% of an estate's built-in capital gains tax. The court based the contingent tax liability and resulting discount on an assumed immediate liquidation of the decedent's interest in a closely held investment holding company, rather than the 16-year indexed discount allowed by the Tax Court. On an issue of first impression for this court, the Eleventh Circuit followed the Fifth Circuit's approach in *Estate of Dunn*, 90 AFTR2d 2002-5527.

When Frazier Jelke III died in 1999 in Miami, he held through a revocable trust a 6.44% interest in Commercial Chemical Company (CCC), a closely held C corporation that held and managed investments for its shareholders. The other CCC shareholders were irrevocable trusts for other Jelke family members. The terms of the trusts did not prohibit the sale or transfer of CCC stock. CCC's primary investments were marketable securities, and the portfolio was well managed by a stockholder-elected board. The investment strategy was long-term capital growth, which resulted in low asset turnover and large unrealized capital gains. There were no plans to liquidate any significant portion of CCC's portfolio.

The federal estate tax return reported the value of Jelke's interest in CCC as \$4,588,155, which was computed by reducing CCC's net asset value by the entire built-in capital gains tax liability, as if the securities had been sold at the date of death, then applying a 20% discount for lack of control and a 35% discount for lack of marketability. The IRS issued a notice of deficiency based on the same net asset value but discounting for the built-in capital gains tax liability by \$21 million, or 41%, to reflect when it was expected to be incurred, and using lesser discounts for lack of control (5%) and lack of marketability (10%).

The Tax Court agreed with the IRS and disallowed the full reduction for built-in capital gains tax liability, on the presumption that the tax would be incurred in the future. However, the Tax Court applied a

10% lack-of-control discount and a 15% lack-of-marketability discount.

In siding with the estate, the Eleventh Circuit used *Dunn's* "snap shot of valuation" approach, which takes into account only the facts known at the date of death "without present values or prophecies," the court said.

In a scathing dissent, Judge Ed Carnes derided *Dunn's* and the instant majority's "rule of least effort," saying "sometimes prophesying is necessary." The Tax Court's calculation produced a result closer to reality than assuming an immediate liquidation, Carnes wrote.

Although this is the first time this valuation issue has come before the Eleventh Circuit, it has been addressed by several other circuits besides the Fifth. The Second Circuit in *Eisenberg v. Commissioner* (82 AFTR2d 98-5757) and the Sixth Circuit in *Estate of Welch* (85 AFTR2d 2000-1200) allowed discounts (less than 100%) for built-in capital gains taxes. The Fifth Circuit vacated the Tax Court's judgment in *Estate of Jameson* (88 AFTR2d 2001-5922) and remanded the case with instructions to allow a discount for built-in capital gains. A year later, the Fifth Circuit reversed the Tax Court again, in *Dunn*. Increasingly since 1998, when the Tax Court in *Estate of Davis* (110 TC 530) began recognizing such discounts, the question has been not whether they can be taken, but by how much. We will likely see more aggressive positions taken in this area. For estate tax valuation, tax advisers may want to consider the cases in their jurisdiction.

■ *Estate of Frazier Jelke III v. Commissioner*, 100 AFTR2d 2007-6694

Prepared by **Karyn Bybee Friske**, CPA, Ph.D., Pickens Professor of Business and associate professor of accounting, and **Darlene Pulliam**, CPA, Ph.D., McCray Professor of Business and professor of accounting, both of the College of Business, West Texas A&M University, Canyon, Texas.

TAX SHELTERS, PENALTIES

ECONOMIC SUBSTANCE PREVAILS AGAINST ANOTHER SON OF BOSS

The IRS scored a major success in its war against Son of BOSS-type tax shelters in *Jade Trading LLC*. The Court of Federal Claims

used the application of the economic substance doctrine in *Coltec Industries* to disallow losses involving partnerships and euro call options.

In 1999, after clearing approximately \$40 million on the sale of their cable businesses in Kentucky, three brothers, Gary, Robert and Tim Ervin, each formed a limited liability corporation. The LLCs each purchased euro options from insurer and financial services company American International Group (AIG) for a premium of \$15,000,020. At the same time, each LLC sold a euro option to AIG for \$14,850,018 and paid AIG the difference, \$150,002. Each LLC then contributed its option spread to Jade Trading LLC, an investment vehicle, and treated its basis as equal to the premium for the purchased call option. In so doing, the brothers' LLCs ignored the premium for the sold call option by claiming that the call options assumed by Jade were contingent obligations. Shortly thereafter, each LLC redeemed its partnership interest at its fair market value—a relatively small amount equal to the difference in the options. In each case, a loss was claimed for the difference between the fair market value of the partnership interest and the claimed basis of almost \$15 million. On their 1999 returns, each Ervin brother claimed close to \$15 million in losses and expenses from the execution of the spread

transaction and involvement in Jade. The IRS audited the returns and disallowed these losses. The Ervins appealed to the Court of Federal Claims.

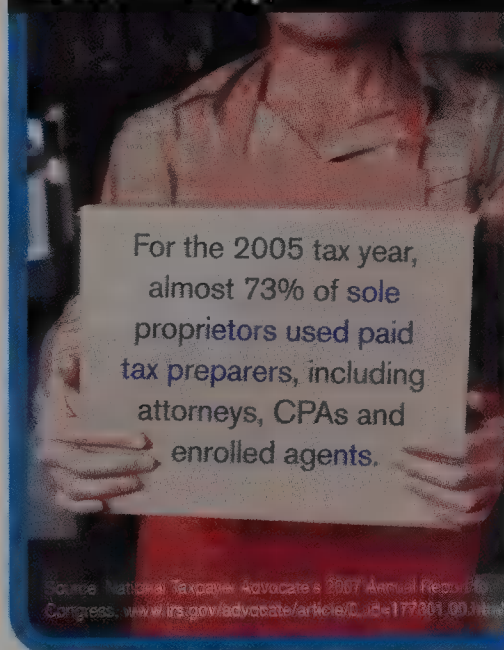
The court held that the Jade transactions failed the economic substance doctrine as clarified in the *Coltec* decision (98 AFTR2d 2006-5249; see also "Tax Matters: Denial of Contingent Liability Loss Deduction," *JofA*, Jan. 07, page 67). In *Coltec*, the Court of Appeals for the Federal Circuit (overturning the Court of Federal Claims) determined that the legitimacy of a transaction for tax purposes is not guaranteed merely because a technical interpretation of the Code would support the tax treatment. In *Jade Trading*, the Court of Federal Claims required additional scrutiny of the bona fides of the transaction, requiring that the transaction pass muster under the objective economic substance test. The court said the taxpayer has the burden of proving that the transaction giving rise to the tax benefit objectively had economic substance—as opposed to a transaction created for tax avoidance purposes.

The court said that the transaction resulted in a fictional loss, had no ability to realize a profit and resulted in a disproportionate tax advantage as compared with the amount invested and potential return. In addition, there was no nontax reason for conducting the original transactions in partnerships. The court upheld the government's \$14.7 million reduction of each partnership's basis, plus a 40% gross valuation misstatement penalty. Because the court considered only partnership items, it lacked jurisdiction to consider the individual partners' defenses to the penalties; these defenses could be taken up subsequently in individual partner-level proceedings.

In Notice 2000-44, 2000-36 IRB 255, the IRS warned that purported losses in arrangements similar to that of *Jade* are subject to challenge on a variety of grounds and that a variety of penalties may be imposed on participants, promoters, and reporters of these listed transactions. Tax shelters have become less attractive due to the IRS's aggressive pursuit of transactions that appear to lack economic substance. Tax advantages gained are less likely to withstand IRS and judicial scrutiny.

■ *Jade Trading LLC v. U.S.*, 100 AFTR2d 2007-5591

Self-Employed Taxpayers Look for Help



Source: National Taxpayers Advocates 2007 Annual Report to Congress. www.irs.gov/advocate/article?cid=177301.00

Prepared by **Alice A. Upshaw**, CPA, MPA, instructor of accounting, and **Darlene Pulliam**, both of the College of Business, West Texas A&M University, Canyon, Texas.

EMPLOYMENT TAXES

PITT FALLS IN FICA CASE

The Third Circuit Court of Appeals recently held that payments to tenured faculty and administrators at the University of Pittsburgh who relinquished tenure rights under an early-retirement plan were subject to FICA taxes. The ruling was contrary to an Eighth Circuit case with similar facts (*North Dakota State University v. U.S.*, 87 AFTR2d 2001-2522).

The Third Circuit, in a split decision that overturned a district court ruling, held that tenure, although awarded on a limited and discretionary basis, was based on past service to the university and was a form of compensation for that service. Therefore, and because the employees' relinquishment of tenure rights was not the primary consideration given by them, the payments represented wages for purposes of FICA, the court said.

Any cash or noncash remuneration received for employment, unless exempted by law or regulation, is considered wages subject to Federal Insurance Contribution Act taxes, which support Social Security and Medicare. The Eighth Circuit in *North Dakota State University* based its decision on the holding of Revenue Ruling 58-301, 1958-1 C.B. 23, that a lump-sum payment to cancel an employee's contract rights was not FICA wages. The IRS in 2002 declined to acquiesce to *North Dakota State University*, stating its belief that the payments arose out of the employer-employee relationship and were made as a consequence of past services performed by the professors that resulted in their tenure. Furthermore, in 2004 the IRS issued Revenue Ruling 2004-110, 2004-2 C.B. 960, which held that payments after Jan. 11, 2005, to cancel an employment contract and relinquish contract rights are subject to FICA.

Between 1982 and 1999, the University of Pittsburgh offered early-retirement plans to tenured professors and administrators.

The plans had a minimum age requirement and required a minimum number of years of service to the university. Plan participants would receive monthly payments if they relinquished their tenure rights. Between 1996 and 2001, the university paid more than \$2 million in FICA taxes on the payments. Later, the university attempted to recover the taxes in a district court action. The district court held, based on Revenue Ruling 58-301, that the payments were made in exchange for contractual rights and thus were not wages subject to FICA taxes.

In its appeal to the Third Circuit, the IRS argued for following the holding of the Sixth Circuit in *Donald F. Appoloni et al. v. U.S.*, 97 AFTR2d 2006-2828. That opinion concluded that payments to public school teachers who gave up their tenure rights under an early-retirement plan were wages for FICA. After examining the terms of the Pitt retirement plans, the Third Circuit agreed. The plans linked eligibility to past service and had a stated purpose of maintaining a competitive compensation package by offering early-retirement incentives. The court also likened the payments to severance payments, which previously have been held to be FICA wages.

In a dissenting opinion, Chief Judge Anthony Joseph Scirica agreed with the university that the payments were given in exchange for property rights (tenure). Tenure at Pittsburgh is not automatically granted after a certain number of years of worthy service but is also based on other factors, such as personnel needs, financial resource constraints and curricular needs, he noted. In addition, the granting of tenure marks the beginning of a new contractual relationship, not a continuation of the old, distinguishing it from severance payments, Scirica wrote.

The decision further muddies the water on this issue. It remains unclear what impact Revenue Ruling 2004-110 might have on similar situations, since it applies to payments made after those of this case.

■ *University of Pittsburgh v. U.S.*, 100 AFTR2d 2007-6504

Prepared by **Charles J. Reichert**, CPA, professor of accounting, University of Wisconsin-Superior. ♦

Line Items

RETURN PREPARER PENALTIES GUIDANCE ISSUED

The IRS said it will revise regulations before the end of 2008 to incorporate provisions of the Small Business and Work Opportunity Tax Act of 2007 concerning preparer penalties under section 6694 and related sections.

In the meantime, interim guidance issued in the final hours of 2007 offered some clarification and relief. Most notably, the interim guidance provides a method for signing tax return preparers to reconcile section 6694's more-likely-than-not certainty threshold for nondisclosed items with the section 6662 "substantial authority" standard for taxpayers. In Notice 2008-13, the Service said that if a position meets section 6662's requirements for nondisclosure, the signing preparer will be deemed to have met the section 6694 requirements if he or she explains to the taxpayer the difference between the two standards and contemporaneously documents that the advice was provided.

Other provisions of Notice 2008-13 provide that the preparer of an information return listed in Exhibit 2 of the notice (or other document, such as a depreciation schedule or cost, expense or income allocation study) will be considered a preparer of a tax return if entries in the information return or other document constitute a substantial portion of that tax return. For example, the preparer of a Form 1065, *U.S. Return of Partnership Income*, may be considered a preparer of a partner's individual income tax return if the entry or entries on the partnership return constitute a substantial portion of the partner's return.

In contrast, the preparer of an information return listed in Exhibit 3 of the notice (such as Form W-2, *Wage and Tax Statement*) will not be considered a preparer of a tax return even if the entries in the information return constitute a substantial portion of that tax return, unless the information return was prepared willfully to understate tax liability "or in reckless or intentional disregard of rules or regulations."

Additional guidance regarding the effective dates for the revisions to section 6694 is provided in Notice 2008-11. Guidance regarding return preparer signature requirements is provided in Notice 2008-12.

Comments on Notice 2008-13 are requested by March 24 and may be submitted by e-mail to Notice.Comments@irs.counsel.treas.gov or by other means described in the notice.

WHISTLEBLOWERS TAKE THEIR CUE

In the first year it was established, along with enhanced rewards for tips on large tax underpayments, the IRS Whistleblower Office received about 80 claims, the IRS said in a news release. About half the claims came in the last two-and-a-half months of 2007. They include a claim of \$2 billion in December 2007, according to the Washington, D.C., law firm that filed it. The firm, the Ferraro Law Firm, said the claim broke the previous record of \$1 billion, which it also submitted two months earlier.

Also in December, the Whistleblower Office's first anniversary, the IRS provided interim guidance on claims and their filing in Notice 2008-4. Effective Dec. 20, 2006, the Tax Relief and Health Care Act of 2006 set rewards at between 15% and 30% (the previous maximum was 15%) of the proceeds collected (now including interest) in an action to which the tipster's information substantially contributed. The amount of tax in dispute

must exceed \$2 million, and if the taxpayer is an individual, that person's gross income for any taxable year in question must exceed \$200,000.

NEW FORM 990 PHASED IN FOR SMALLER EOs

Smaller exempt organizations received transition relief as the IRS released its revamped Form 990, *Return of Organization Exempt From Income Tax*, for tax years 2008 and following. Organizations with gross receipts under \$1 million or total assets under \$2.5 million will be allowed to use Form 990-EZ for tax year 2008. The short form is four pages, as opposed to 11 pages plus applicable schedules for the long form. The limit falls in stages to \$200,000 in gross receipts and \$500,000 in total assets for tax years beginning with 2010. Still, that's double the cutoff for the 2007 tax year. Also for 2010, still-smaller organizations will double their limit from the 2007 amount for eligibility to file by e-postcard (Form 990-N), to \$50,000 in gross receipts.

NEW AND INCREASED FILING PENALTIES FOR BUSINESSES

Among the revenue offsetting provisions of HR 3648, the Mortgage Forgiveness Debt Relief Act of 2007, were increases in penalties on partnerships and S corporations for failure to timely file returns. The monthly penalty for failure to file required partnership returns on time (absent any extension) was increased from \$50 per partner to \$85 per partner. The maximum number of months the penalty may be assessed was increased from five to 12. Likewise, for S corporations, the act added new IRC § 6699, which imposes a penalty of \$85 per month per shareholder for failure to timely file. The penalties are effective for returns required to be filed after the law's enactment in December 2007.

Relief provisions of the act included most prominently the exclusion of dis-

charge-of-indebtedness income of up to \$2 million received on or after Jan. 1, 2007, from forgiveness of a mortgage on a taxpayer's qualified principal residence.

SUPREME COURT UPHOLDS TRUST EXPENSE FLOOR

The Supreme Court ruled in a unanimous opinion that administrative expenses of nongrantor trusts or estates generally are subject to the 2% of adjusted gross income floor as miscellaneous itemized expenses, resolving a split among circuit courts on the issue. The case, *Knight v. Commissioner* (101 AFTR2d 2008-380), was styled as *Rudkin Testamentary Trust v. Commissioner* in lower court proceedings. At issue was the exemption under IRC § 67(e) from the floor for expenses that "would not have been incurred if the property were not held in such trust or estate." While agreeing with the Second Circuit's result (98 AFTR2d 2006-7368), the Supreme Court criticized its analysis. Rather than asking, as the Second Circuit held, whether a trust expense *could* have been incurred by an individual, the statute requires asking whether it *would customarily* be incurred by an individual, the Supreme Court said. To determine that, the court said, the trustee must predict what would happen if the property were held in the hands of an individual. Moreover, if the trustee can show that he incurred some extra, incremental cost that an ordinary individual investor would not have incurred, it would be fully deductible. The opinion addressed only investment adviser fees and did not discuss trustee fees, tax preparation fees or other costs.

On similar facts and arguments, the Sixth Circuit in 1993 allowed exemption from the floor for investment advisory fees a trustee paid to meet fiduciary requirements under state law (*William O'Neill Jr. Irrevocable Trust v. Commissioner*, 71 AFTR2d 93-2052).

SMALL BUSINESS CHOICE OF ENTITY

Partnership Incorporation Provides Planning Opportunities

It is common for business owners to conclude that they must change the legal form of the entity through which a business has been conducted. When incorporating a business that has been a partnership, CPAs should pay close attention to the form of the conversion because the method used can affect the tax consequences of the transaction.

Rev. Rul. 84-111 provides three ways to incorporate a partnership: (1) the "assets-over" method, in which partnership assets are transferred to a newly formed corporation; (2) the "assets-up" method, in which partnership assets are distributed to the partners in liquidation of the partnership, followed by the contribution of the assets to a newly formed corporation; and (3) the "interests-over" method, in which partnership interests are transferred to a newly formed corporation in exchange for corporate stock. The specific method used affects basis, gains or losses, and holding periods.

Generally, Rev. Rul. 84-111 applies the rules of subchapter C on transfers to corporations; the rules of subchapter K on partnership distributions, transfers of partnership interests, and the treatment of unrealized receivables, inventory, and liabilities; and the rules of subchapter P on the holding period of property to each method of incorporation. The tax consequences will vary under each method because the basis in and the holding period of the assets held by a partnership, the partners' basis in and holding period for their interests in the partnership, and the character of the assets held by the partnership, the partner, and the corporation will vary under each method.

For example, when the partners' basis in their partnership interests is equal to the partnership's basis in its assets, regardless of the method used to incorporate the partnership, the corporation's basis in the assets after the incorporation will be the same as the basis of the assets when held by the partnership. However, when the basis in partnership interests does not equal the basis of partnership assets, differences will arise as a function of which method is used.

Caution: The tax consequences described in Rev. Rul. 84-111 are premised on the actual execution of all the steps inherent in the incorporation of a partnership, as a function of the method used.

SECTION 1244 STOCK CONSIDERATIONS

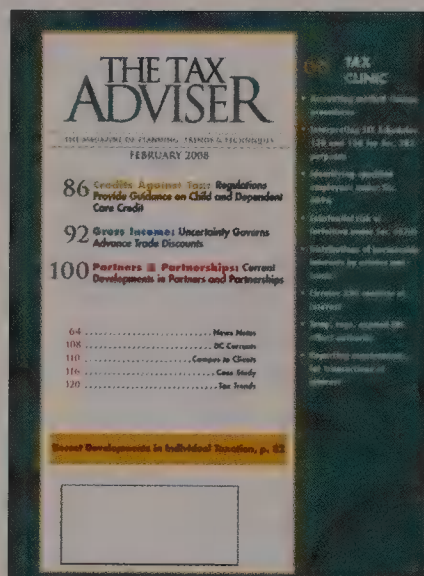
Taxpayers should compare the tax consequences to identify the method that yields the most favorable tax outcome, looking at basis, holding periods, and character of assets or interests transferred.

For example, since the original owner of section 1244 stock is the only taxpayer eligible to claim an ordinary loss from the sale or worthlessness of the small business stock, using the assets-over method of incorporating a partnership would void the

section 1244 treatment. Under the assets-over method, the partnership serves as an intermediary owner in the process of transferring the stock to the former partners, and section 1244 treatment is lost when the stock is transferred by the partnership to the partners. Section 1244 treatment is preserved with both the assets-up and interests-over methods because the partners take ownership of the stock directly in the exchange.

For a detailed discussion of the issues in this area, see "Holding Period and Basis Considerations of Conversions to and from Partnerships," by Jonathan Sousa, MBA, and Kathleen M. Weiden, CPA, Ph.D., in the March 2008 issue of *The Tax Adviser*.

—Alistair M. Nevius, editor-in-chief
The Tax Adviser



Also find articles on the following topics in the March 2008 issue of *The Tax Adviser*:

- Roundup of state corporate tax developments.
- Report on abusive tax shelters.
- Commentary on the new protocol to the U.S.-Canada tax treaty.

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New & Noteworthy

What's the best retirement plan for small business?

Get help for the toughest questions with new edition of CPA's guide.

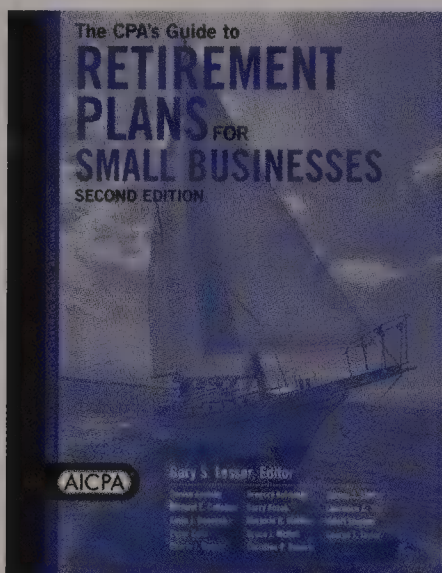
by Barry Kozak Adapted from *The CPA's Guide to Retirement Plans for Small Businesses, Second Edition*

Simply stated, the best retirement plan is the one that comes closest to satisfying the needs and objectives of the client, the adopting employer. Matching those needs to the various types of available plans and the myriad possible plan designs is often more difficult than defining the employer's needs and objectives. The benefits and costs associated with establishing, maintaining and terminating the plan, and the life of the plan must all be considered. The motivation of the employees and the demographics of an employer may also be relevant factors in choosing the right plan.

For example, a simplified employee pension plan (SEP) program can compare favorably with a qualified plan even though fully vested SEP contributions would generally be made for transient employees with three or more years of service. A qualified plan's shorter eligibility requirement (generally, a service requirement of one year and 1,000 hours) may result in contributions having to be made or allocated to more employees. Although the qualified plan would most likely have a vesting schedule applied to employer-derived accrued benefits or account balances, it is applied to an additional two years of contributions made by the employer. The plan that offers the least employee cost at all points along an employee's employment time line can be determined only after considering factors such as potential growth of business, employee turnover, age, whether employed on the last day of the plan year, worked

at least 500 or 1,000 hours, work patterns, and so on.

The right plan can be selected by design, but the decision often involves the elimination of unsuitable plan types followed by the selection and design of the best plan from those that remain. For example, an employer that is unable to commit to a contribution level would not ordinarily adopt a pension plan. A 401(k) plan would not be suitable for a smaller business owner if non-highly compensated employees (NHCEs) choose not to make elective contributions. A SEP may be more suitable for a smaller business owner if there is high turnover in early years. It is generally better not to make a contribution for an employee than to rely on a vesting schedule or forfeiture provision.



The CPA's Guide to Retirement Plans for Small Businesses (2nd Edition)

Edited by Gary S. Lesser
Product # **017257**
AICPA Member Price: **\$89.00**

The design of cross-tested plans is both an art and a science. The enormous complexity of the IRS regulations in this area provides both opportunities and pitfalls for the practitioner. The need to have competent assistance on an initial and ongoing basis cannot be overemphasized. This is not an area in which the intelligent practitioner can afford to go it alone. The risk of mistakes being made is high and the penalty can be catastrophic, for both the client and the practitioner.

Barry Kozak, JD, LLM, EA, MSPA, ChFC, is associate director of graduate employee benefits programs at the John Marshall Law School, Chicago. This is adapted from ***The CPA's Guide to Retirement Plans for Small Businesses, second edition***, product # 017257 now available at www.cpa2biz.com, or toll-free 1-888-777-7077.

New Resources

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Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Practice Aid

This new edition is intended to help practitioners better understand and apply Statement on Quality Control Standards (SQCS) No. 7 which is included in this practice aid.

No. 006636

\$40.00 member/\$50.00 nonmember

CPE Self-Study

Avoiding Circular 230 Malpractice Traps and Common Abusive Small Business Hot Spots, by Sam Adams

This new self-study course enables the practitioner to better understand the many abusive insurance and annuity-based products being marketed to clients and how you can alleviate exposure to IRS scrutiny.

Prerequisite: None

Recommended CPE credit: 6

Level: Intermediate

Format: Text, \$120.00 member/\$150.00 nonmember

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\$119.00 member/\$148.75 nonmember

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Text, No. 732492; DVD/Manual, No. 181429

Recommended CPE credit: Text, 10; DVD/Manual, 12

Level: Basic

Text, \$129.00 member/\$161.25 nonmember;

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Checklists and Illustrative Financial Statements for State and Local Governments

No. 009037

\$39.00 member/\$48.75 nonmember

CPE Direct

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Level: Basic

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Paperback, No. 017257

\$89.00 member/\$111.25 nonmember

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Life Cycle Planning for the CPA Practice: Practical Strategies and Forms

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June 19-20, 2008 – New York, NY
- **AICPA Business Valuation School**
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June 23-27, 2008– Phoenix, AZ
July 14-18, 2008– Atlanta, GA
August 18-22, 2008– Lewisville (Dallas), TX

Webcast

- **SEC Webcast Series - 4 Quarterly Webcasts - \$249.00**
- **CFO Webcast Series - 4 Quarterly Webcasts - \$249.00**

Technology Q&A

by Stanley Zarowin

Avoid getting shocked by a thunderstorm...Send personalized e-mails using Word's Mail Merge tool...Eliminate Outlook's second-guessing when typing an e-mail address...Make Vista's interface look like XP's—with no loss of functionality...A better way to display several files on your screen

AVOID GETTING SHOCKED BY A THUNDERSTORM

Q We're getting into the spring thunderstorm season, and here in the Midwest the lightning can be quite impressive—and destructive. I especially worry about my computer system's vulnerability. My computer is plugged into a power strip. How can I be sure the power strip provides enough protection? Any thoughts on this?

A Most power strips are definitely not enough protection; they just function as extension cords and usually provide little or no defense from lightning. What you need is a surge protector. A good surge protector should not only protect your gear from lightning strikes, it should offer insurance to cover the loss of properly attached equipment. However, be aware that even the best surge protectors may not protect your equipment from a direct hit to your building. Be sure your surge protector also has an R-11 telephone jack so you can safeguard your phone, too. And if you're connected to cable for the Internet, look for a unit that accommodates the cable hookup, too. You can get an adequate device for less than \$50.

You may want to consider protecting your whole office because a nearby lightning strike can blow out all your electrical and electronic equipment. You can buy a surge protector for a small building for between \$150 and \$300; however, it needs to be installed on your electric meter or service panel by a licensed electrician.

Another option—and one that I strongly endorse—is to buy a good uninterruptible power supply (UPS) that has built-in

surge protection. In the event of a power outage, the UPS—which is basically a large battery—keeps the computer running just long enough for it to automatically save any open files and then shut down. Such a device costs less than \$100 to serve one computer and considerably more for larger setups.

Caveat: The conventional wisdom used to be that plugging a surge protector between the wall outlet and a UPS would provide double protection against lightning. However, now some leading vendors of both types of products not only advise against doing this, they warn that it would nullify their products' warranties.

Now the only thing you have to worry about during a thunderstorm is staying dry and not standing under a tree.

SEND PERSONALIZED E-MAILS USING WORD'S MAIL MERGE TOOL

Q I frequently send e-mails to clients reminding them of deadlines or special services. To protect the recipients' identities I use the Bcc (blind copy) in the address box. While that approach is OK, the message still appears somewhat like a cheesy broadside advertisement because the e-mails aren't personalized with a *Dear George Smith*, for example. However, to personalize each one would take too much time. There's got to be a better way. Can you help?

A There is a better way. As you know, Outlook can use Word for word processing, and that gives you access to Word's **Mail Merge** tool, which fortunately adapts itself easily to producing personalized e-mails as well as letters, envelopes and labels. And the good news is that the tool works the same as a standard **Mail Merge** and equally well in both Office 2007 and 2003. In other words, it lets you generate personalized e-mails, addressing them from a choice of contact lists—such as Outlook or an Excel spreadsheet, among others.

To launch Outlook's **Mail Merge**, start by typing your message in Word and then, if you're using Office 2007, click on the **Mailings** tab in the ribbon; if you're using Word 2003, click on **Tools, Letters and Mailings**. The **Mail Merge** wizard screens look different in the 2003 and 2007 versions, but they contain practically the same instructions (see screenshots on following page).

» Key to Instructions

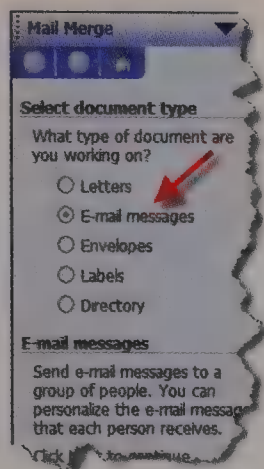
To help readers follow the instructions in this article, we use two typefaces:

Boldface type is used to identify the names of functions, menu items, icons, agendas and URLs.

Sans serif type shows the names of files and the names of commands and instructions that users should type into the computer.



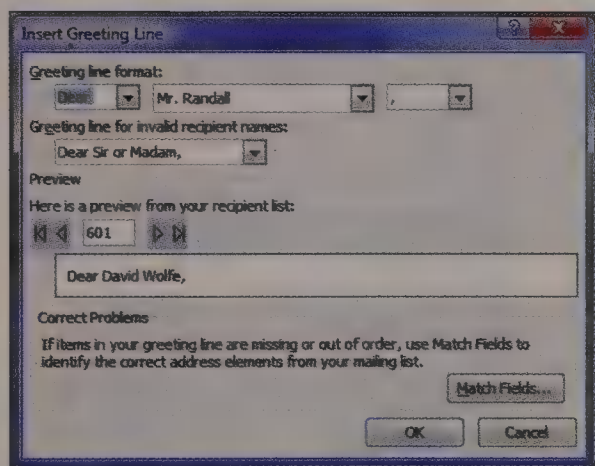
Word 2007 Mail Merge



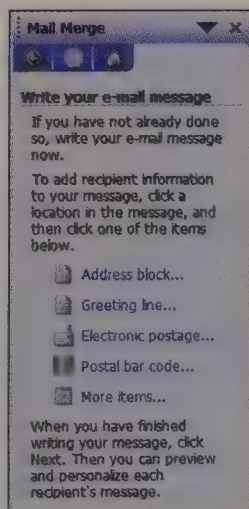
Word 2003 Mail Merge

Then just follow the wizard as it takes you through all the setup steps. When the wizard asks you to select the recipients of the e-mail, you have several choices: You can select them from your **Outlook** contacts list, an Excel spreadsheet, or you could type them in.

The next step is to add the appropriate fields that personalize the greeting (see screenshot below).



The Word 2007 screen



The Word 2003 screen

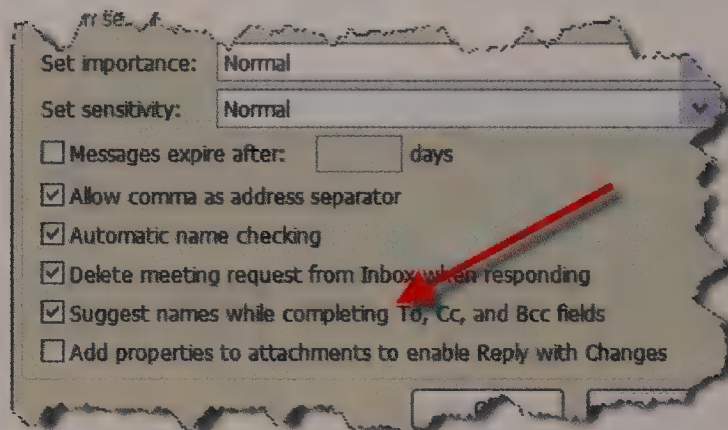
Once you click on **OK**, the fields for the greeting lines and any other information you added can be reviewed. When you're satisfied, click on **Finish** and **Send E-mail Messages**. Outlook automatically takes it from there, adding the names and addresses for each message and sending them along.

ELIMINATE OUTLOOK'S SECOND-GUESSING WHEN TYPING AN E-MAIL ADDRESS

Q I use **Outlook** for e-mail, and when I begin to type an address, the program automatically completes the address based on the previous e-mail message I sent. And, of course, that's usually not the address I want. How can I stop that automatic action?

A You'll be happy to learn that the Microsoft engineers wisely provided a way to stop this feature.

Go to **Tools, Options, Preferences, E-Mail Options, Advanced E-Mail Options**, and then uncheck the box next to **Suggest names while completing To, Cc, and Bcc fields**.



MAKE VISTA'S INTERFACE LOOK LIKE XP'S—WITH NO LOSS OF FUNCTIONALITY

Q OK, I'm using Vista, but not because I like it. I upgraded because I just must to stay current with the new technology. But I sure would be delighted if I could go back to that classic XP and still maintain the Vista functionality.

A Well, you can at least go back to the XP interface, and you can do that without losing any Vista functionality—just the Vista view.

Change from this...

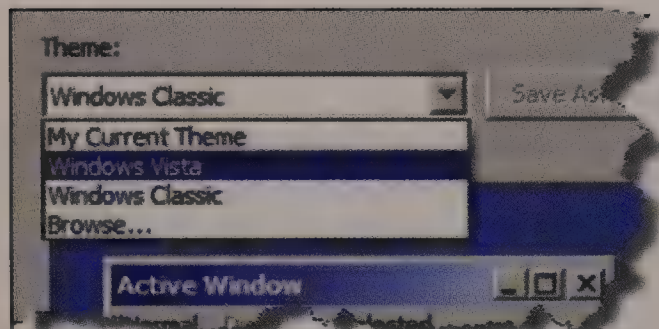


...to this.

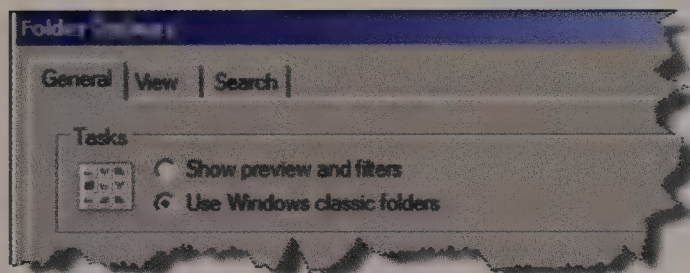


Here's how to do it: Go to the **Start** button and right-click, select **Properties**, **Classic Start Menu** and click on **OK**.

Right-click on any blank place on the desktop and select **Personalize**, **Choose Theme** and then, from the **Theme** pull-down menu, click on **Windows Classic** and on **OK**.

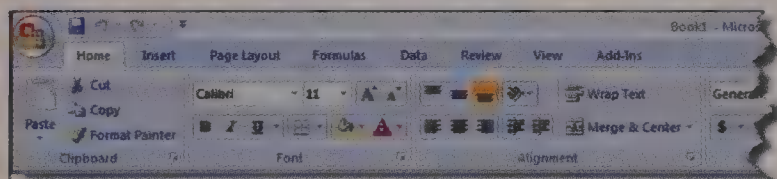


Now go back to the **Start** menu and open the **Documents** folder, click on the **Organize** button, select **Folder and Search Options** and then **Use Windows classic folders**. Finally click on **OK** and you're back to the XP look.



And for those who want to replace the **Ribbon** in Excel 2007 (see screenshot) with the traditional interface, check out **ToolbarToggle** (www.toolbartoggle.com) or **Classic Menu** (www.addintools.com/english/menuoffice).

Change from this...



...to this.



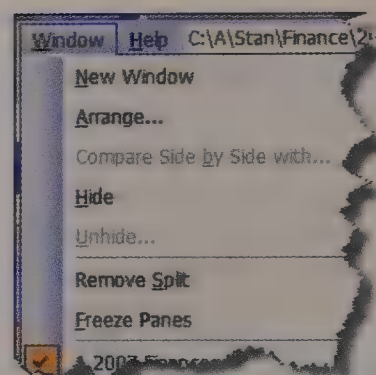
A BETTER WAY TO DISPLAY SEVERAL FILES ON YOUR SCREEN

Q I often need to display parts of a Word document and several Excel workbooks on my screen at the same time. In Office 2003 I do that by clicking first on the **Window** menu in the toolbar, but is there a better way?

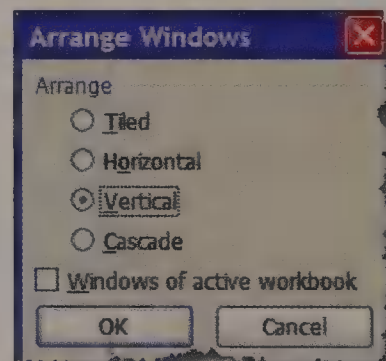
A Yes, I can suggest a much better way—especially since you apparently need to repeatedly set up the multiview format. But first let's take a moment to illustrate the method you use for those who are not familiar with it and only need to do it occasionally.

With that method, not only can you display parts of several files on the screen, you also can adjust their sizes and independently perform all your usual tasks.

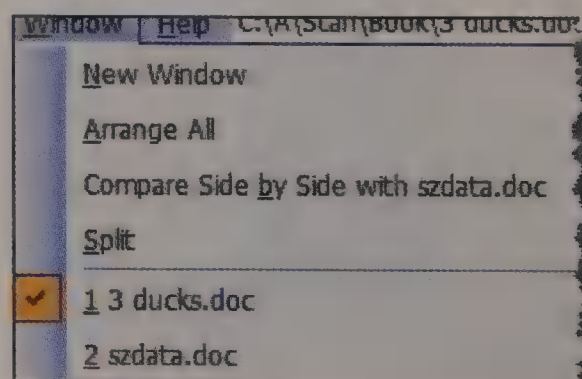
In Office 2003, begin by opening your first document or spreadsheet and then click on **Window**. If you want to arrange multiple views just of that file, click on **Split** and a horizontal line will appear in the middle of the document. When you place your cursor in either portion, you can move around and edit it— independent of the other portion.



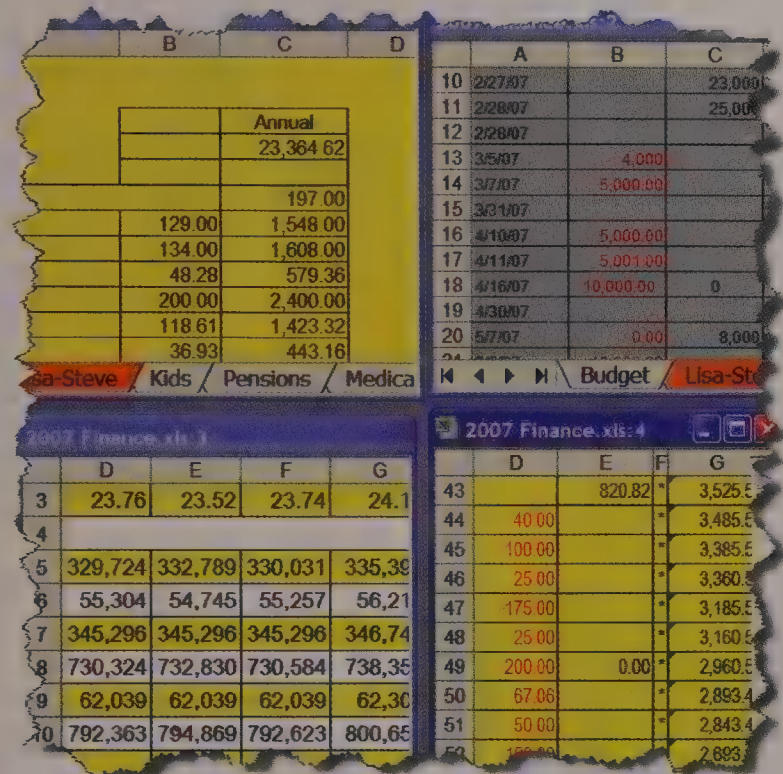
If you click on **Arrange**, this screen appears, letting you select how to line up the views.



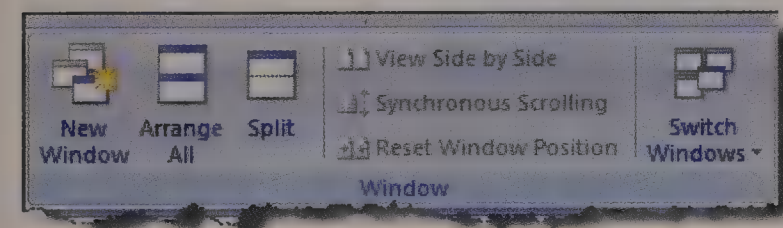
If you open another file and click on **Compare Side by Side with...** (select from the choices at the bottom of the menu which file you want added to the screen).



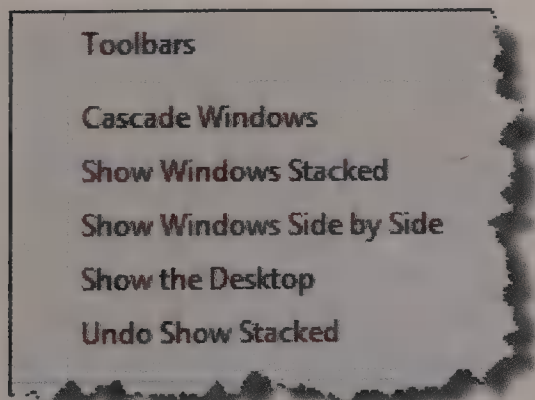
As you can see from the screenshot below, you can open more files and click and drag them for the best arrangement on your screen. The number of files and their size and arrangement is limited only by the size of your monitor.



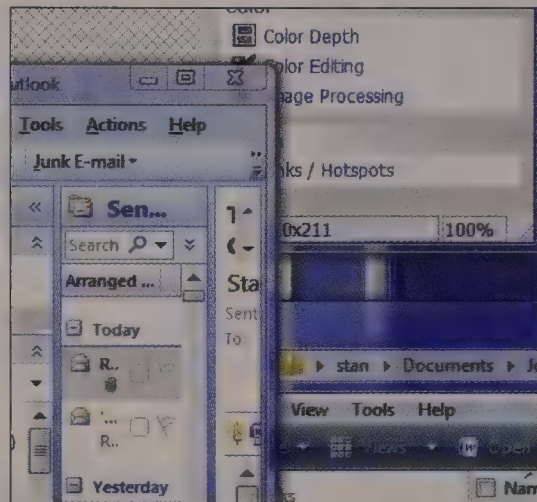
Office 2007 has two methods. One is by clicking on **View** in the **Ribbon**, and as you can see from the screenshot below, the conveniently arranged buttons in the menu make it easier to set up your views.



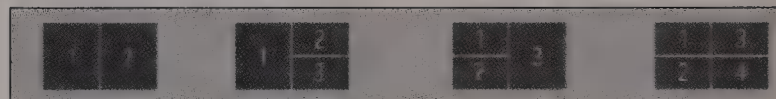
The other way is to open the files you want. Then right-click on the toolbar, producing this screen.



Whether you choose to **Cascade Windows**, **Show Windows Stacked** or **Show Windows Side by Side**, you can maneuver the screens any way you wish with your mouse and, by grabbing the edges of any image, shorten or widen them for a convenient fit—even allowing some overlap.



But I promised you an even more powerful and faster way to place multiple files on your screen. AcerGridVista is a freeware program (no cost for personal or commercial use) that can divide your screen into as many as four sections in any of the following arrangements:



Once you select any of the configuration arrangements above and open the files you want displayed, you can drag and drop them into a box of your choice; the software will automatically resize them to fit in the box. You also can set a window to always remain on top or to be semi-transparent (so you can see what's under it). And it will remember your latest arrangement the next time you want to set up multiple screens.

To download the program, go to www.softpedia.com/program/Download/Acer-Gridvista-Download-71638.html.

Stanley Zarowin is a contributing editor to the *JofA*. His e-mail address is stanley.joatech@gmail.com.

Do you have technology questions for this column? Or, after reading an answer, do you have a better solution? Send them to me via e-mail at stanley.joatech@gmail.com or via regular mail at the *Journal of Accountancy*, 220 Leigh Farm Road, Durham, NC 27707-8110.

Because of the volume of mail, I regret I cannot individually answer submitted questions. However, if a reader's question has broad interest, I will answer it in a forthcoming Technology Q&A column.



BOOKSHELF REVIEW

Recommended Reading From the JofA

■ *Life Cycle Planning for the CPA Practice: Practical Strategies and Forms*

by Martin M. Shenkman, CPA, MBA, J.D., PFS
AICPA, 2007, 183 pp.

As accounting practices grow, they often experience similar milestones. Author Martin Shenkman's book gives accountants a framework to guide the growth of their practice, providing details needed for careful analysis of major business, tax and planning decisions at every phase. The milestones, and book chapters, are arranged in chronological order to discuss the planning, structuring and documentation of each life cycle stage to help readers understand the specific issues involved.

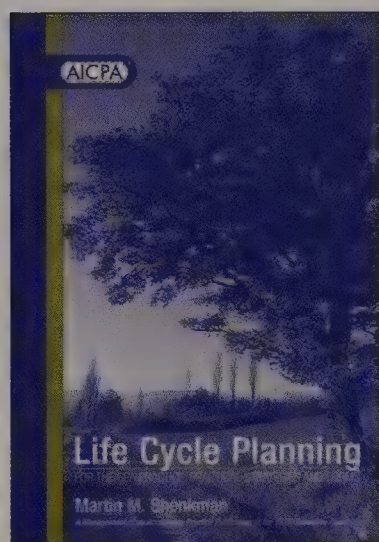
The cycles are identified as setting up a solo practice, hiring staff, transitioning staff from employee to prospective partner status, adding a partner, buying a practice, growing into a multi-partner practice and retirement, terminating a partner, or winding down a practice. Each chapter provides detailed instructions and resources on these topics.

The book also includes a CD of sample forms, letters and checklists that readers can use to plan and execute the outlined strategies. Armed with the details contained in this book, owners or partners can become better educated to make the necessary decisions for the longevity and success of their firms.

By JofA Senior Editor **Loanna Overcash**

■ *At the Crossroads: The Remarkable CPA Firm That Nearly Crashed, Then Soared*

by Gale Crosley, CPA, and Debbie Stover
John Wiley and Sons, 2008, 208 pp.



This story follows a fictional accounting firm, C&P, through its journey from dysfunction and slow growth to success. Although not a novel, the authors use a narrative format to teach readers about the Practice Growth Model, a way of looking at the resources needed to achieve effective growth for improved firm profitability.

Since taking over as managing partner seven years earlier, Joe Abriola realizes his firm has missed opportunities for growth. When the C&P partners also become aware of their failure to measure up against similar-sized firms, tensions and accusations mount. Change is clearly necessary for the firm's survival.

Joe calls on a friend, Alex, who used a disciplined growth model to overcome his own firm's struggles when he became managing partner 18 years prior. Since that time, Alex's firm has successfully sustained 20% revenue growth.

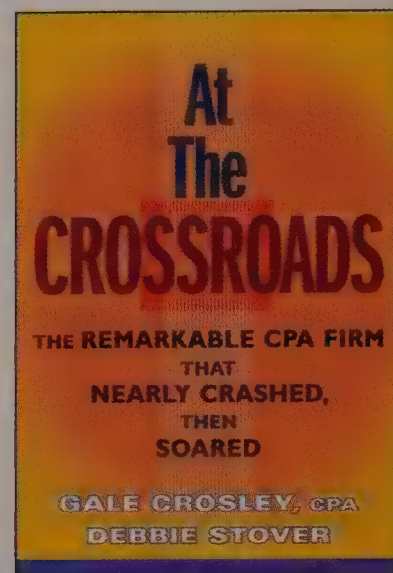
With Alex's guidance, Joe leads the C&P team of partners through an off-site strategic summit to develop a three-year plan for the firm's revitalization. For C&P to grow, they need to develop a common vision and plan. The partners agree that they want to see 15% growth in overall revenues. But their current infrastructure does not support this type of growth.

The C&P partners must implement a system of best practices for disciplined growth that includes:

- Developing a common client profile, or set of descriptors, that will help the firm become more efficient in identifying and servicing clients.
- Keeping an up-to-date inventory of active opportunities.
- Developing revenue segmentation where leaders of either industry niches or service lines own revenue and profit responsibilities for that segment and are held accountable for its direction.
- Managing products effectively based on a discipline of defining, designing and developing a service before it is promoted.

As the changes are integrated, the partners and staff of C&P develop more synergy in their work and improvements are made. Of course, it isn't an easy transformation for everyone, and they lose some people along the way who don't or won't perform up to expectations. But, overall, as the firm puts its strategy into action, they gain greater visibility, progressing in targeted business segments. The growing pains seem worth the effort when three years into the implementation of the plan, the firm is well on its way to achieving the long-term growth it first sought to obtain.

By JofA Senior Editor **Loanna Overcash**



■ **Make More, Worry Less: Secrets From 18 Extraordinary People Who Created a Bigger Income and a Better Life**

by Wes Moss, CFP

FT Press, 2008, 220 pp.

If your New Year's resolution about finding more satisfaction—monetary or otherwise—on the job has begun to fade, Wes Moss has a pep talk designed to get you back on track.

Moss is a certified financial planner in Atlanta. Fans of Donald Trump's "The Apprentice" may recognize Moss' name from among the contestants on the second season of the reality TV show.

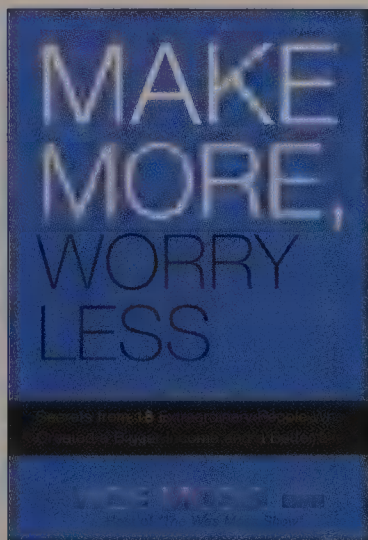
Moss' worry-fighting tips include sitting down at the beginning of each year to write out the year's goals, both business and personal. He says that kind of goal-setting helped him get his stress under control.

He also advises readers to look for ways to turn roadblocks into resources. He took advantage of the time spent in Atlanta's notorious traffic snarls to conduct interviews for his latest book and an earlier one, *Starting From Scratch: Secrets From 21 Ordinary People Who Made the Entrepreneurial Leap*.

In this book, Moss tells the stories of 18 people who found ways to earn more while worrying less. He begins with Linda Rabb, a food service worker who found a healthy six-figure salary and long-term security from the insurance services company Aflac.

In the chapters that follow, Moss offers varied examples of ordinary professionals who found more control over their careers and enhanced security by looking at work with a more entrepreneurial mind-set.

By JofA Senior Editor **Kim Nilsen**



■ **100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States**

by Michael J. Graetz, LL.B., the Justus S. Hotchkiss Professor of Law

Yale University Press, 2008, 254 pp.

Michael Graetz, a Yale Law School professor, has written many books and studies related to major tax reform. His previous books on income tax reform may be familiar to readers—*The Decline (and Fall) of the Income Tax* (1997) and the 1999 paperback version *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go From Here*. Graetz's titles indicate the progression of his thoughts and research in a series of studies, which have culmi-

nated in his plan for comprehensive reform that is the subject of this book. Graetz probably hopes that Congress adopts the basics of his plan so that his trilogy can be complete. However, his fear is perhaps that instead this is only the start of a long series.

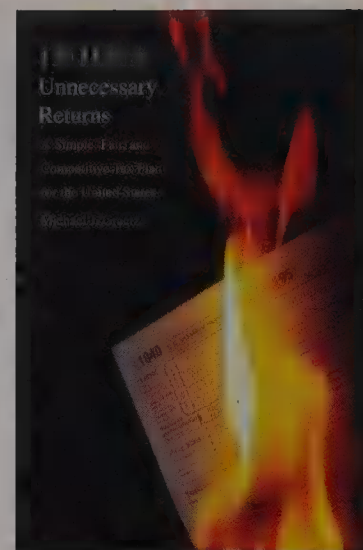
Graetz states that his plan "offers a nonideological, reasoned, fiscally sound and feasible way to modernize our tax system. It would avoid shifting the tax burden away from those most able to pay to families with less income or wealth, while allowing us to fund our government in a manner more conducive to economic growth and increasing standards of living for all Americans." This plan, the Competitive Tax Plan, consists of six parts: (1) Enact a value-added tax; (2) eliminate the income tax for most Americans; (3) lower the corporate income tax rate; (4) retain the estate and gift taxes; (5) introduce a payroll adjustment or "smart cards" to protect low- and moderate-income workers; and (6) create incentives for states to adopt a similar model.

Businesses with annual gross receipts of less than \$100,000 would be exempt from the value-added tax; married couples with incomes under \$100,000 (\$50,000 for single individuals) would not pay income taxes. Graetz offers a creative solution to minimize the regressive effect of a consumption tax with a "smart card" or payroll adjustment. To make more corporate income subject to tax and to discourage tax shelters, Graetz recommends greater conformity between book and tax accounting for publicly held companies.

Readers of earlier works will recognize the basics of the Graetz plan, but will discover many more details in this book. Graetz outlines the details of his plan while comparing it to other plans for major tax reform. Interested citizens without a tax background can understand his clearly written explanations, while the details in footnotes and appendices provide enough supporting information to satisfy the more serious tax expert.

All CPAs could find value in reading this book. Those in tax practice obviously need knowledge of tax reform proposals and by reading this book they could gain a basic understanding of all the major plans. Graetz's comparison of his plan to the other plans serves as a primer on tax policy issues that are central to the debate over tax reform. Regardless of when (or if) one of these proposals is enacted, CPAs who read the book will be able to respond to questions from clients and other parties with an interest in this debate. Accountants who are not tax practitioners also have a stake, at the least as taxpaying citizens. Armed with this knowledge, CPAs can and should have a voice in the debate over the future of our federal and state tax systems.

By **Tonya K. Flesher**, CPA, Ph.D., professor of accountancy at the Patterson School of Accountancy, University of Mississippi



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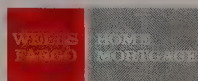
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EXPOSURE DRAFTS OUTSTANDING

(This list was compiled as of Jan. 22, 2008. For exposure drafts issued after that date, consult *The CPA Letter*.
 Note: The policy for updating the list of exposure drafts is that a document should remain on the list until a final document has been issued or the project has been dropped. However, no comments will be received after the comments deadline has expired.
 The list is not all-inclusive but is intended to present the exposure drafts of particular interest to professional accountants.)

Issue Date	Title or Description	Comment Deadline	Issue Date	Title or Description	Comment Deadline
FASB			3/7/01	Statement on Standards for Continuing Professional Education Programs	8/1/01
4/18/07	Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60	6/18/07	SEC		
12/8/06	Disclosures About Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133	3/2/07	6/26/02	Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process; Release Nos. 33-8109; 34-46120; 35-27543; IA-2039; IC-25624	9/3/02
10/9/06	Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition (an amendment of FASB Statement No. 142)	1/29/07	5/10/02	Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies (Release Nos. 33-8098; 34-45907)	7/19/02
10/9/06	Not-for-Profit Organizations: Mergers and Acquisitions	1/29/07	4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 33-8090	6/24/02
9/30/05	Earnings per Share—an amendment of FASB Statement No. 128 (revision of Exposure Draft issued 12/15/03)	11/30/05	4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 34-45742	6/24/02
8/11/05	Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140	10/10/05	2/18/00	SEC Concept Release: International Accounting Standards	5/23/00
4/28/05	The Hierarchy of Generally Accepted Accounting Principles	6/27/05	1/21/00	Supplementary Financial Information	4/17/00
AcSEC (AICPA)			GAASB		
9/12/07	Proposed Audit and Accounting Guide, Airlines	12/15/07	6/29/07	Accounting and Financial Reporting for Derivative Instruments	10/26/07
ASB (AICPA)			10/20/06	Fund Balance Reporting and Governmental Fund Type Definitions (Invitation to comment)	1/31/07
5/9/05	Proposed Statement on Auditing Standards: Amendment to Statement on Auditing Standards No. 69, <i>The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles</i> , for Nongovernmental Entities	6/27/05	IFAC		
ARSC (AICPA)			1/15/08	Proposed Redrafted International Standard on Auditing ISA 210 (Redrafted), Agreeing the Terms of Audit Engagements	4/15/08
10/9/07	Omnibus Statement on Standards for Accounting and Review Services—2008	12/28/07	1/15/08	Proposed Redrafted International Standard on Auditing ISA 710 (Redrafted), Comparative Information—Corresponding Figures and Comparative Financial Statements	4/15/08
OTHER (AICPA)			12/21/07	Proposed New International Standard on Assurance Engagements ISAE 3402, Assurance Reports on Controls at a Third Party Service Organization	5/31/08
12/3/07	Proposal of Professional Ethics Division, Interpretation on Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Agreements With a Client	2/3/08	12/21/07	Proposed New International Standard on Auditing ISA 265, Communicating Deficiencies in Internal Control	4/30/08
8/13/07	Proposal of Professional Ethics Division, Interpretation on Networks and Network Firms and Proposed Related Definitions	11/13/07	12/21/07	Proposed Revised and Redrafted International Standard on Auditing ISA 402 (Revised and Redrafted), Audit Considerations Relating to an Entity Using a Third Party Service Organization	4/30/08
5/15/07	Proposed Interpretation 102-7, Other Considerations: Meeting the Objectives of the Fundamental Principles, and Proposed Framework for Meeting the Objectives of the Fundamental Principles	8/15/07	12/21/07	Proposed Redrafted International Standard on Auditing ISA 501 (Redrafted), Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures	3/31/08
4/16/07	Proposed Revisions to the AICPA Standards for Performing and Reporting on Peer Reviews	6/30/07	12/21/07	Proposed Redrafted International Standards on Auditing ISA 520 (Redrafted), Analytical Procedures	3/31/08
12/13/06	Proposed Revisions to AICPA/NASBA Uniform Accountancy Act Section 23	5/15/07	10/15/07	Proposed Revised and Redrafted International Standard on Auditing ISA 505 (Revised and Redrafted), External Confirmations	2/15/08

Issue Date	Title or Description	Comment Deadline
10/15/07	Proposed Revised and Redrafted International Standard on Auditing ISA 620 (Revised and Redrafted), Using the Work of an Auditor's Expert	2/15/08
10/1/07	Consultation Paper—Proposed Strategy for 2009–2011	11/30/07
9/5/07	Amendments to IPSAS 4, The Effects of Changes in Foreign Exchange Rates	12/31/07
8/3/07	Proposed Redrafted International Standard on Auditing and International Standard on Quality Control ISA 220 (Redrafted), Quality Control for an Audit of Financial Statements ISQC 1 (Redrafted), Quality Control for Firms That Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements	12/31/07
8/3/07	Proposed Redrafted International Standard on Auditing ISA 700 (Redrafted), The Independent Auditor's Report on General Purpose Financial Statements	11/30/07
8/3/07	Proposed Redrafted International Standard on Auditing ISA 705 (Revised and Redrafted), Modifications to the Opinion in the Independent Auditor's Report	11/30/07
8/3/07	Proposed Redrafted International Standard on Auditing ISA 706 (Revised and Redrafted), Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report	11/30/07
8/3/07	Proposed Redrafted International Standard on Auditing ISA 800 (Revised and Redrafted), Special Consideration—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	11/30/07
8/3/07	Proposed Redrafted International Standard on Auditing ISA 805 (Revised and Redrafted), Engagements to Report on Summary Financial Statements	11/30/07
7/31/07	Proposed Redrafted International Standard on Auditing ISA 510 (Redrafted), Initial Audit Engagements—Opening Balances	10/31/07
7/31/07	Proposed Redrafted International Standard on Auditing ISA 530 (Redrafted), Audit Sampling	10/31/07
5/1/07	ISA 250 (Redrafted), The Auditor's Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements	7/31/07
5/1/07	ISA 200 (Revised and Redrafted), Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance With International Standards on Auditing	9/15/07
5/1/07	ISA 500 (Redrafted), Considering the Relevance and Reliability of Audit Evidence	9/15/07
3/1/07	Proposed Redrafted International Standard on Auditing, ISA 570 (Redrafted), Going Concern	5/31/07
3/1/07	Proposed Revised and Redrafted International Standard on Auditing, ISA 550 (Revised and Redrafted), Related Parties	6/30/07
1/4/07	Practical Experience Requirements—Initial Professional Development for Professional Accountants	3/31/07
12/29/06	Proposed Revised Section 290 of the Code of Ethics for Professional Accountants, Independence—Audit and Review Engagements, and Proposed Section 291, Independence—Other Assurance Engagements	4/30/07
12/22/06	Proposed Revised and Redrafted International Standard on Auditing ISA 580 (Revised and Redrafted), Written Representations	4/30/07

Issue Date	Title or Description	Comment Deadline
12/22/06	Proposed Revised and Redrafted International Standard on Auditing ISA 540 (Revised and Redrafted), Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures Proposed Withdrawal of ISA 545, Auditing Fair Value Measurements and Disclosures	4/30/07
12/22/06	Proposed Redrafted International Standard on Auditing ISA 230 (Redrafted), Audit Documentation	3/31/07
12/22/06	Proposed Redrafted International Standard on Auditing ISA 560 (Redrafted), Subsequent Events	3/31/07
12/22/06	Proposed Redrafted International Standard on Auditing ISA 610 (Redrafted), The Auditor's Consideration of the Internal Audit Function	3/31/07
12/22/06	Proposed Redrafted International Standard on Auditing ISA 720 (Redrafted), The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	3/31/07
12/1/06	Strategic and Operational Plan, 2007–2009	2/28/07
11/22/06	Proposed Amendment to International Public Sector Accounting Standard, "Financial Reporting Under the Cash Basis of Accounting," "Financial Reporting Under the Cash Basis of Accounting—Disclosure Requirements for Recipients of External Assistance"	3/31/07
11/15/06	Proposed Drafted International Standards on Auditing ISA 320 (Revised and Redrafted), Materiality in Planning and Performing an Audit ISA 450 (Redrafted), Evaluation of Misstatements Identified During the Audit	2/15/07
11/15/06	Proposed Redrafted International Standard on Auditing Proposed ISA 260 (Revised and Redrafted), Communication With Those Charged With Governance	2/15/07
10/26/06	Proposed International Public Sector Accounting Standard, Employee Benefits	2/28/07
10/18/06	Proposed International Public Sector Accounting Standard, Impairment of Cash-Generating Assets	2/28/07
3/24/06	Proposed International Standard on Auditing 600 (Revised and Redrafted), The Audit of Group Financial Statements	7/31/06
FASAB		
8/3/07	Reporting Gains and Losses From Changes in Assumptions and Selecting Discount Rates and Valuation Dates	1/15/08
6/11/07	Implementation Guide for SFFAS 29: Heritage Assets and Stewardship Land	8/13/07
6/4/07	Clarification of Standards Related to Inter-Entity Cost	8/6/07
5/21/07	Accounting for Federal Oil and Gas Resources	1/11/08
10/23/06	Accounting for Social Insurance, Revised (Preliminary Views)	4/16/07
PCAOB		
10/17/07	An Audit of Internal Control That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies	12/17/07
4/3/07	Proposed Auditing Standard—Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards	5/18/07

Issue Date	Title or Description	Comment Deadline	Issue Date	Title or Description	Comment Deadline
5/23/06	Proposed Rules on Succeeding to the Registration Status of a Predecessor Firm	7/24/06	10/26/04	Proposed Rule on Procedures Relating to Subpoena Requests in Disciplinary Proceedings	11/29/04
5/23/06	Proposed Rules on Periodic Reporting by Registered Public Accounting Firms	7/24/06	XBRL 12/5/07	US GAAP Taxonomies and related documentation public review	4/4/08

INFORMATION

The initials stand for the following organizations. Exposure drafts are available online at the Web addresses below or copies may be obtained at the address in parentheses (unless otherwise indicated).

FASB— Financial Accounting Standards Board (Order Department, Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); also available online at www.fasb.org

GASB— Governmental Accounting Standards Board (Order Department, Governmental Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); also available online at www.gasb.org

AICPA— American Institute of CPAs (American Institute of Certified Public Accountants, 220 Leigh Farm Road, Durham, NC 27707-8110). AICPA publishes exposure drafts exclusively on the Web at www.aicpa.org. Print copies are not available.

IASB— International Accounting Standards Board (International Accounting Standards Board, 30 Cannon Street, London EC4M 6XH, United Kingdom), also available online at www.iasb.org

IFAC— International Federation of Accountants (International Federation of Accountants, 545 Fifth Avenue, 14th Floor, New York, NY 10017); also available online at www.ifac.org

SEC— Securities and Exchange Commission (Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549); also available online at www.sec.gov

FASAB— Federal Accounting Standards Advisory Board (Federal Accounting Standards Advisory Board, 441 G Street, N.W., Suite 6814, Washington, DC 20548); also available online at www.fasab.gov

PCAOB— Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, DC 20006-2803; www.pcaobus.org

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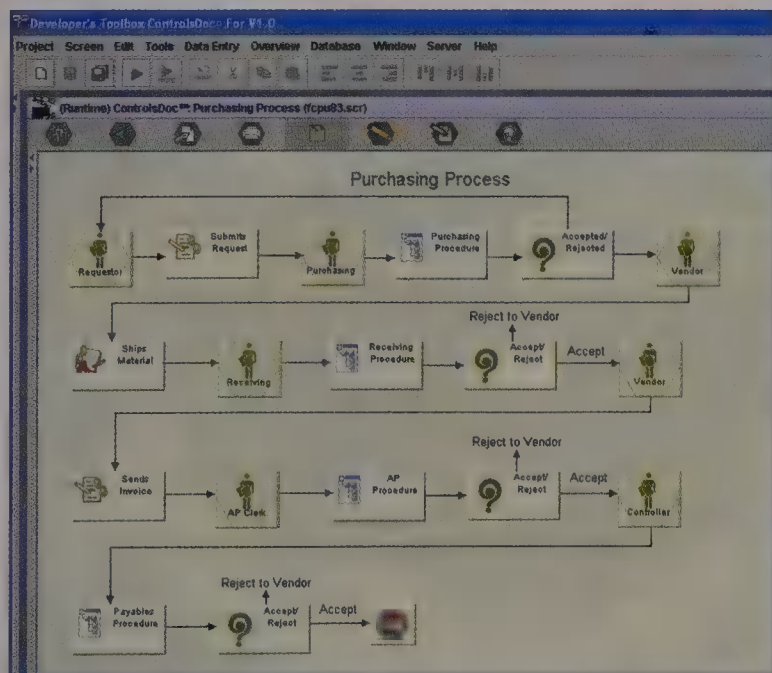
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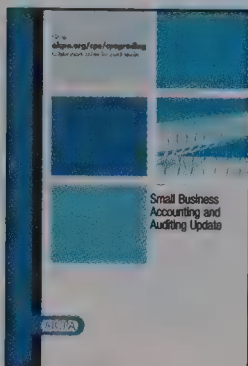
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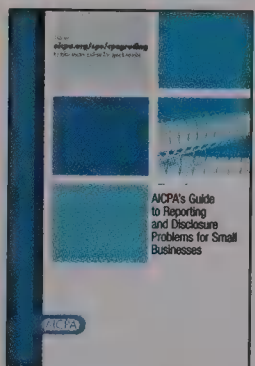
- Apply recently issued FASB Statements and Interpretations to accounting issues
- Apply recently issued Statements on Auditing Standards, Statements on Standards for Accounting and Review Services and Statements on Standards for Attestation Engagements to accounting and auditing problems

Prerequisite: None

NASBA Field of Study: Accounting and Auditing

Level: Update

Recommended CPE Credit:
20 (Accounting—10, Auditing—10)



734336JA3

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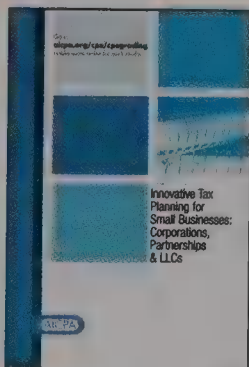
- Apply generally accepted accounting principles to specific problem areas in compilation, review or audit engagements
- Prepare appropriate footnote disclosures
- Use OCBOA when appropriate

Prerequisite: None

Level: Basic

NASBA Field of Study: Auditing

Recommended CPE Credit: 12



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This CPE self-study course covers state-of-the-art planning ideas and tax-saving devices employed by the savviest practitioners in order to keep more profits in the pockets of your corporate clients and business owners.

Objectives

- Understand the unique tax problems affecting corporations
- Identify savings opportunities and pinpoint tax traps
- Explain changes in each client's tax situation
- Planning under the 2006 and 2005 Tax Acts

Prerequisite: Basic knowledge of corporate income taxation

NASBA Field of Study: Taxes

Level: Intermediate

Recommended CPE Credit: 16



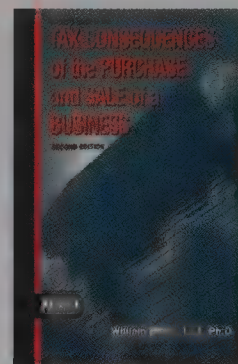
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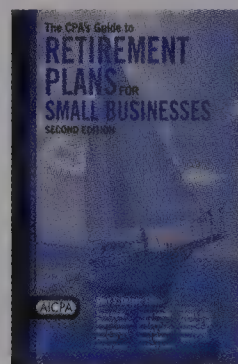
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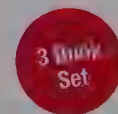
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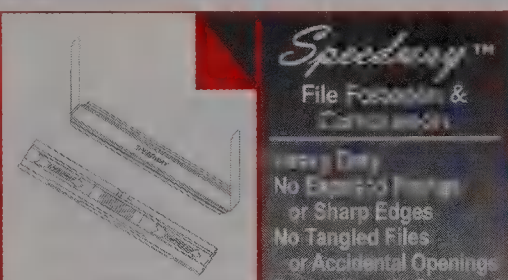
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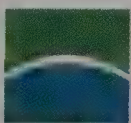
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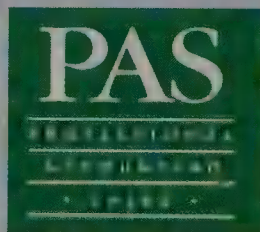
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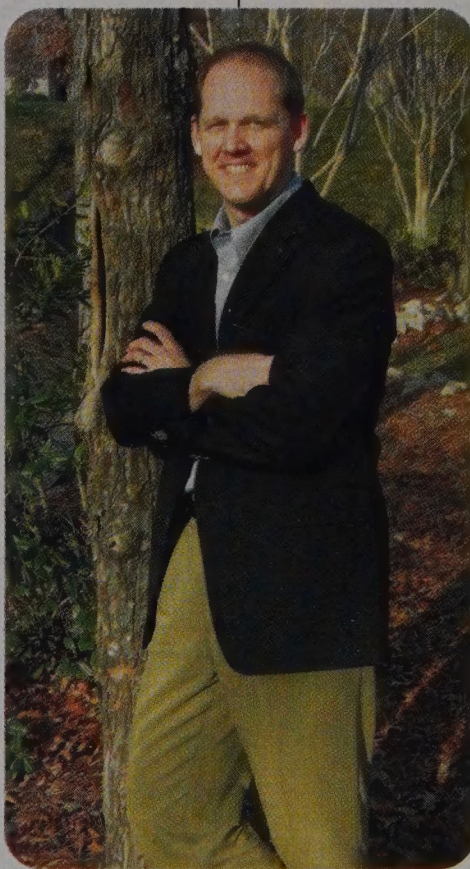
THE LAST WORD

The Young CPA Gulf Coast trip gave me a renewed sense of faith in humanity. I led a group of 10 volunteers from the North Carolina and Louisiana societies on a small business disaster-recovery project in New Orleans in November 2007. Over four days, we reached 100 small businesses and non-profits through one-on-one coaching sessions and group presentations. We partnered with Operation HOPE, an international nonprofit with a presence along the Gulf Coast. They provided the infrastructure, and we provided the volunteers.

One team member worked with a woman to file her tax returns for the last three years. He not only completed her straightforward returns, but bought her a new computer. She thought she had won the lottery. Somebody showed her their hope and confidence in her ability to take care of business. Now she is in good standing with the IRS and is free to focus on rebuilding her business.

Accounting has the potential to be a means to a greater good. It is a people-oriented profession. As CPAs, we agreed to serve the public when we sat for the exam. My constant quest is to tie professional skills into community service. It hit me one day that we have practical skills to help people rebuild their lives after a disaster.

About nine months into my first job at Ernst & Young, I volunteered for a church mission trip to Brazil. It was the first time I had been out of the country, and it profoundly affected my worldview. Since that time, I have struggled between earning a decent living and wanting to help folks. I started a nonprofit with a college friend. Outreach Inc. is a rehab builder in Birmingham, Ala., and is still alive and well. But I did return to public accounting. I held a job as an internal auditor with an international company, working in both Minnesota and Wisconsin with occasional trips to Europe. After the company was bought out, I took another job within the company and moved my wife and family to North Carolina. That's how I found the N.C. Association of CPAs, who I've been with for over seven years now.



Tom Pender, CPA
Director of finance and administration,
N.C. Association of CPAs
Raleigh, N.C.

As NCACPA's director of finance and administration, I'm responsible for our information technology, peer review and general administration.

The most rewarding part of my job is interacting with members and, in particular, our young CPAs. About five years ago, the board of directors established a Young CPA Cabinet and asked me to be the staff liaison (I still was a young CPA). This was a natural place to take the idea for the Gulf Coast project, but it certainly has the potential to move beyond young CPAs.

It will take months and years to know the impact and success of both the Operation HOPE and CPA Gulf Coast projects. This is just the beginning. Operation HOPE will track people who move through the program. Ultimately, people will move from needing assistance to being able to pay for the help. An outsider might say this is self-serving for the profession, but we are investing in these folks with the hope and confidence that their businesses are going to come back.

The Mississippi Society has already committed to a May project. The Illinois Society has a team scheduled for next summer, and a dozen other states have expressed interest. Plans are in the works for three trips in 2008. I will continue to act as the liaison (tlpender@ncacpa.org) for state societies and individuals interested in volunteering through Operation HOPE. My goal is to send multiple teams of volunteers down there from all over—a wave of CPAs. And of course, members of the Louisiana Society, local CPAs of the Gulf Coast area and other volunteer organizations remain vigilant in their efforts and hard work.

The Gulf Coast is going to rebuild itself—the question is how? The heart of the recovery effort is small business, and no one else speaks this language better than CPAs. We can provide owners and managers with the tools they need to recover and help the people of this area do it as smartly as possible.

—As told to Loanna Overcash

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"Hiring good employees had been a problem for our firm, but no longer. AccountantsWorld showed us how to use stay-at-home accountants to work for us at their convenience. The web-based Accounting Relief lets these professionals work from home just as effectively as if they were sitting in our office."

You'd be surprised at how many of the business problems you face can be solved by AccountantsWorld—like attracting and retaining great staff, growing your practice, keeping up with technology, finding more time for clients, or achieving a better work/life balance.

Why AccountantsWorld?

Not just because AccountantsWorld has an unparalleled blend of breakthrough products, services, resources and training, but also because of its knack for finding uncommon, simple ways to let you do more and make your practice better.

Want to learn more about how to solve your staffing problem?

Visit www.AccountantsWorld.com—the favorite destination for accountants, or call 888-999-1366.



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Resources: The 110,000-member strong AccountantsWorld.com online community and portal, Taxsites.com, and ABACUS magazine.

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Calculate Your Lockhart Advantage™ and get paid for all you're worth.			
1. The Value Of One Client Now:			
Average revenue of one client per year	\$4,000	\$4,000	
Average client retention (years)	10	10	
Cost of capital (%)	20%	20%	
Net contribution margin (%)	40%	40%	
Net Present Value (NPV) of one client now	\$5,708	\$5,708	
2. Billing And Retention: What If You Could Increase One Client's...			
Projected billings by 1% (or more)?	1%	2%	
Retention by 1 year (or more)?	100%	100%	
Current number of clients you serve	1,000	1,000	
Client Present Value with Lockhart Advantage™	\$5,708	\$7,245	
Your Lockhart Advantage for one client	\$1,537	\$1,537	
3. New Client Acquisition: What If You Could Increase...			
Target conversion ratio by 1% or more?	1%	2%	
New prospects per year	500	500	
Value added with Lockhart Advantage™ per year**	\$1,537	\$1,537	
New clients added per year	\$34,963	\$72,445	
New Client Acquisition Lockhart Advantage™	\$168,581	\$262,976	
Your Total Lockhart Advantage™	\$431,681	\$640,798	

Visit www.LockhartAdvantage.com/calculate

Request your free sample kit #JB308 today!